STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company	)	
	)	
Application for Review of Alternative Regulation Plan	)	Docket No. 98-0252
	)	
Illinois Bell Telephone Company	)	
	)	
Petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates	)	Docket No. 98-0335
	)	
	)	
Citizens Utility Board, People of the State of Illinois	)	Docket No. 00-0764
v.	)	
Illinois Bell Telephone Company	)	(Consol.)

BRIEF ON EXCEPTIONS OF AMERITECH ILLINOIS

Louise A. Sunderland
Karl B. Anderson
Mark A. Kerber
Illinois Bell Telephone Company
225 West Randolph Street, HQ-25D
Chicago, Illinois 60606
(312) 727-6705
(312) 727-7140
(312) 727-2928

Edward A. Butts
1800 West Hawthorne Lane, Room 102
West Chicago, Illinois 60185
(630) 562-1515

Dated: June 13, 2001

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BRIEF ON EXCEPTIONS OF AMERITECH ILLINOIS

Illinois Bell Telephone Company (hereafter "Ameritech Illinois" or "the Company"), by its attorneys, hereby files its Brief on Exceptions in the captioned proceeding.

I. SUMMARY OF POSITION

Ameritech Illinois generally supports the Hearing Examiners' Proposed Order in this proceeding. When the Commission substituted price regulation for rate of return regulation in 1994, it adopted an entirely new regulatory model which would meet the demands of a changing and increasing competitive marketplace over the long run. The Proposed Order recognizes the significance of that change and ensures that the key benefits of price regulation -- the benefits which led the Commission to adopt it in the first place -- will continue. The soundness and adaptability of the Plan is further underscored by the sweeping new legislation which was recently passed by the Illinois General Assembly (H.B. 2900). Based on Ameritech Illinois' initial review of this legislation, the Alternative Regulation Plan is only minimally affected. To the extent that changes required by this Act warrant revisiting certain conclusions which the Proposed Order recommends, Ameritech Illinois will address those implications at appropriate points in this Brief on Exceptions.[1]

Under price regulation plans in general and the Alternative Regulation Plan in particular, the link between the regulated utility's prices and its costs is severed. The price index ensures that customers who use the Company's noncompetitive services are protected from both unreasonable price changes and the competitive, economic and financial risks faced by the Company. In return, Ameritech Illinois is allowed to run its business like any other company and earn what the marketplace permits. This incentive structure changes corporate behavior and induces more efficient, market-oriented business practices. In resolving key disputed issues, such as what constitutes "just and reasonable rates" under a price regulation plan, the Proposed Order appropriately reconciles statutory requirements with the relevant policy, economic and legal considerations underlying price regulation and the trade-offs inherent in the Plan adopted by the Commission in 1994.

There are, however, certain aspects of the Proposed Order which are of concern to Ameritech Illinois. One of the major deficiencies of the Plan during its initial term is that it provided no meaningful pricing flexibility to the Company. Ameritech Illinois' rates for residence network access lines were last established in 1990, over 10 years ago. The Company strongly believes that the Plan should provide some modest capability to increase prices within

[1] The new legislation is, of course, extensive and the Company's analysis is necessarily preliminary.

the context of the annual price cap filings to permit gradual movement towards a more economic rate structure. The Company also believes that the Proposed Order's treatment of wholesale offerings such as UNEs is unlawful and must be changed.

The Proposed Order's analysis of service quality issues is also generally correct, well reasoned and consistent with the evidence in the record. In particular, the Proposed Order chooses a reasonable set of service quality measures and benchmarks that will assure both the Commission and consumers that service is maintained at appropriate levels, focusing on those aspects of service quality which most affect customers. However, certain aspects of the Proposed Order should be revised. Most importantly, the Proposed Order would increase service quality penalties dramatically, even where there is no evidence that the existing penalties are insufficient. The Proposed Order should also be revised to reflect the new service quality remedies that will be imposed through Section 13-712 of H.B. 2900. In addition, the proposed benchmarks for Installation within Five Days and Missed Repair Commitments are inappropriate, and the Proposed Order's reasoning in adopting those benchmarks is fundamentally inconsistent with other portions of the Proposed Order.

Ameritech Illinois is also concerned about the Proposed Order's treatment of the issues associated with its service cost studies. Service cost studies are essential predicates to new rate design proposals. Unfortunately, the Proposed Order simply raises concerns relative to one of Ameritech Illinois' key service cost models (LFAM, which establishes the cost of a loop) as part of an overall decision to deny the Company's rate rebalancing proposal. These concerns are not supported by substantial evidence in the record. Moreover, this disposition of the contested issues leaves the Company without an approved cost study methodology which can be used in future proceedings.

As will be discussed in more detail later in this Brief on Exceptions, the Company is withdrawing the rate rebalancing proposal at this time in order to assess the potential impact of H.B. 2900 on the Company's rate structure. Thus, there is no immediate need to resolve the contested service cost issues. However, to avoid duplicative litigation in future proceedings and the potential for stalemates over rate design issues, Ameritech Illinois urges the Commission either to approve its service cost models based on this record or, at a minimum, to direct the Company and Staff to work together now to resolve the issues, prior to the filing of new tariffs.

Ameritech Illinois' Brief on Exceptions will follow the general format of the Proposed Order. However, rate rebalancing and service cost issues will be addressed at the conclusion of this document. To the extent that the Company proposes editorial or other minor changes to the Proposed Order, they will only be discussed in the Company's Exceptions.

II. THE STATUTORY GOALS AND CRITERIA[2]

The record in this proceeding demonstrates that the Plan functioned well over its initial five-year term and met the statutory goals and criteria in Section 13-506.1. The Proposed Order's conclusions on these issues are, for the most part, supported by the record and are sound. With respect to a few of the statutory criteria, however, the Proposed Order expresses certain reservations which are not supported by substantial evidence and should be changed.

[2] The Proposed Order sets out conclusions on the 10 questions posed by the Commission in the 1994 Order separately (Section II of the Proposed Order). Ameritech Illinois questions this organizational structure. To the extent that issues arose with respect to any of these questions, they are resolved elsewhere in the Proposed Order and the discussion of the parties' positions is duplicative in Section II. To the extent no issues arose, which is the case for many of them, the Commission's conclusions serve little purpose. The only contested issue which is not addressed elsewhere is the impact of the Plan on universal service. This issue could be added onto the discussion of prejudice or disadvantage to customers (HEPO, Section III, 6), or the public interest (HEPO, Section III, 10). Ameritech Illinois recommends that Section II be eliminated, with only a general discussion reflective of these circumstances. Otherwise, it must be substantially expanded to include Ameritech Illinois' affirmative and rebuttal positions on issues discussed therein. The Company's Exceptions address both alternatives.

A. THE PLAN RESULTED IN FAIR, JUST AND REASONABLE RATES

The Proposed Order concludes that the Plan produced fair, just and reasonable rates over its initial term. The proposed Commission Analysis and Conclusion recognizes that this determination cannot be made simply by comparing earnings under one regulatory scheme -- i.e., rate of return regulation -- with earnings under an entirely different regulatory scheme -- i.e., price regulation. The Proposed Order states correctly that "alternative regulation plans regulate the price of services, rather than a company's earnings." (HEPO, Section III, 1, Commission Analysis and Conclusion, par. 1, emphasis added). With respect to this price performance, the Company's going-in rates were determined to be fair, just and reasonable and these rates have since declined under the index, notwithstanding modest levels of inflation. (Id., par. 2). The Proposed Order also properly finds that the analysis of fair, just and reasonable rates applies only to the noncompetitive services which were subject to the Plan. (Id., par. 3).

Ameritech Illinois is concerned, however, to the extent that the Proposed Order goes beyond this analysis and further relies on a "zone of reasonableness" test which Staff advanced in its Reply Brief. (Id.) This portion of the Proposed Order's conclusion should be modified to better reflect the legal and policy considerations relevant to examining prices under a price regulation plan.

The core of the "just and reasonable" analysis must be the price performance of the services subject to the price index. In the 1994 Order, the Commission found that, once having established just and reasonable rates under traditional rate of return principles, the price index would ensure that just and reasonable rates continued over the life of the Plan. That is because the index appropriately reflects the impact of economy-wide cost changes which should be flowed through to consumers, less an appropriate productivity offset.

In fact, Ameritech Illinois' noncompetitive service rates performed precisely as the Commission expected. The record demonstrates that the price index included appropriate measures for both inflation (GDPPI) and the productivity offset, which flowed through to consumers <u>all</u> of the productivity gains achieved by the Company during the 1995-1999 period. (Am. Ill. Ex. 1.1, pp. 29-30; Am. Ill. Ex. 2.1, pp. 7-9). As the Commission predicted in its 1994 Order, the real <u>and</u> actual prices of noncompetitive services fell significantly over the 1995-1999 period. (Am. Ill. Ex. 1.1, p. 68). Both Mr. Hoagg, Staff's principal policy witness, and Dr. Staranczak, Staff's lead economist, were fully satisfied with the overall price performance of Ameritech Illinois' noncompetitive services. (Tr. 1217, 1223-26, 1249-54). Accordingly, the Commission can and should conclude on that basis alone that Ameritech Illinois' noncompetitive service prices are fair, just and reasonable within the meaning of Section 13-506.1(b)(2).

As the Proposed Order acknowledges, this conclusion is supported by the affordability analysis which Ameritech Illinois presented. (HEPO, Section III, 1, Commission Analysis and Conclusion, par. 7). By comparing rate changes under the Plan to both the CPI and changes in wage levels over the 1994-99 period, the Company demonstrated that its noncompetitive rates are significantly more affordable today than they were in 1994. (Am. Ill. Ex. 1.1, pp. 13-14, 72-73).

This focus on price performance is entirely consistent with the testimony of Staff's chief economic witness in this proceeding, Dr. Staranczak. Dr. Staranczak testified that price performance was the threshold test which should be applied in determining whether Ameritech Illinois' rates are just and reasonable and the only test if that threshold analysis was satisfactory.

In response to persistent questioning by GCI's counsel, he stated that traditional earnings analyses were not relevant in those circumstances:

> "I don't think the Commission should be looking at earnings. They should be looking at the price performance of the products that are regulated. And if the price performance is satisfactory, then I don't think the Commission should look at earnings." (Tr. 1249-50).

Thus, the Proposed Order overstates the difference between Ameritech Illinois' and Staff's positions on this issue. (HEPO, Section III, 1, Commission Analysis and Conclusion, par. 7).

The Proposed Order's suggestion that there is a "zone of reasonableness" which governs Ameritech Illinois' earnings levels is unnecessary and will invite more litigation. GCI has conducted an analysis of Ameritech Illinois' earnings under traditional rate case principles and contends that they do not fall within any such zone. In contrast, Ameritech Illinois demonstrated that the initial period of the Plan coincided with a period of record corporate profits; for example, companies like Quaker Oats, General Mills and Campbell Soup earned returns thousands of basis points higher than Ameritech Illinois'. (Am. Ill. Ex. 8.0, pp. 8-10; Am. Ill. Ex. 1.4, p. 28). If there is to be a "zone of reasonableness", GCI will undoubtedly contend that the Commission must define what the bounds of that zone are, which will simply continue the debate over earnings. Fundamentally, the concept of a "zone of reasonableness" has its roots in rate of return principles and it should not be pursued in this proceeding.[3]

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[3] Indeed, one could argue that earnings sharing is premised on there being a "zone of reasonableness" for the regulated company's earnings -- albeit a much narrower zone than the Proposed Order contemplates. Both Staff and Ameritech Illinois took the position that earnings sharing essentially was rate of return regulation and the Proposed Order reaches the same conclusion. (HEPO, Section V, F.)

Moreover, there is a regulatory downside to this zone approach as well. Presumably, Ameritech Illinois would be entitled to rate increases if its earnings fell below a "reasonable" level. The Company recognizes Staff's view that it might seek relief if its earnings fall below a level which the Company finds acceptable and/or which allows it to fulfill its obligations to consumers in this state. However, Staff witness Staranczak also agreed that any such request would result in a highly contested case. (Tr. 1269-70).

By this discussion, Ameritech Illinois is not suggesting that the Commission cannot ever, under any circumstances, examine its earnings levels. The Company acknowledges that the Commission could view extraordinarily high earnings as an early warning signal that some component of the Plan may have malfunctioned, thereby warranting further investigation. Order in Docket 92-0448/93-0239, adopted October 11, 1994, at p. 92. However, in the context of this proceeding, earnings are not relevant to any material issue. The parties have examined every component of the Plan and the index in exhaustive detail. It is undisputed on the record that GDPPI worked well as a measure of inflation over the first five-year term of the Plan and the X factor captured Ameritech Illinois' productivity gains over that period. Once those findings have been made, then there is no policy basis for further review of earnings.

In any event, even if a more expansive role for earnings analysis were appropriate -- which it is not -- that does not mean that the Company's financial results should be viewed from the traditional rate case perspective. The earnings analyses presented by GCI (and Staff) contain endless adjustments to Ameritech Illinois' actual revenues, expenses and rate base for calendar year 1999. These adjustments inflate the Company's so-called "rate of return" by thousands of basis points, leading to demands that its rates be reduced by hundreds of millions of dollars which Ameritech Illinois never earned. This kind of fictional restatement of the Company's earnings has no place under a price regulation plan. It is justified -- if at all -- in a rate of return context, where ratepayers are legally obligated to provide the regulated company an opportunity to earn a reasonable return on its investment. In that environment, the Commission typically conducts a review of the regulated company's operations to ensure that ratepayers are not bearing the costs of imprudent or unreasonable business decisions. Here, as a price regulated company, Ameritech Illinois may not flow through to ratepayers the costs associated with <u>any</u> of its decisions. Indeed, one of the Commission's objectives in 1994 was to sever the link between costs and rates so as to protect ratepayers from those effects. The flip side of this bargain is that earnings -- if they are examined at all -- should be based on actual financial data, unadjusted to achieve rate of return objectives.

In the event that the Commission retains this discussion of a "zone of reasonableness", at a minimum it should be confined to earnings on noncompetitive services. GCI's earnings analysis was based on Ameritech Illinois' total, jurisdictional operations, and it included both competitive and noncompetitive services. As the Proposed Order clearly and correctly finds, however, the Alternative Regulation Plan only applies to noncompetitive services:

> "Staff also contends, and we agree, that the analysis of fair, just and reasonable rates under the Plan applies only to rates for non-competitive services. We read the statute just this way." (HEPO, Section III, 1, Commission Analysis and Conclusion, par. 3).

Consistent with this view, Staff witness Hoagg -- the only Staff policy witness to rely on earnings information at all in his analysis of just and reasonable rates -- testified that he would be concerned only if the Company's earned return on <u>noncompetitive</u> services was inordinately high, if this return had been sustained over a considerable period of time and if further analysis suggested that the Plan had malfunctioned. (Tr. 1223, 1225-26). The uncontroverted evidence in this record is that Ameritech Illinois' noncompetitive services earned only 5.55% in 1999, well below Ameritech Illinois' weighted cost of capital as it would be determined in a traditional rate of return proceeding. (Am. Ill. Ex. 1.6, p. 23; Am. Ill. Ex. 6.0, p. 40; Staff Ex. 11.0, p. 32). In fact, a 5.5% return is so low, the Company questions whether it would even fall within a "zone of reasonableness", were the Commission to establish one. In short, Ameritech Illinois urges the Commission to decide the "just and reasonable" rate issue based on price performance alone.

B. The Plan Resulted In Efficiency Gains And Cost Savings

The Plan met the statutory criteria relative to efficiency gains and cost savings. As the Proposed Order concludes, the X factor worked as expected. (HEPO, Section III, 5, Commission Analysis and Conclusion). In fact, it flowed through the entirety of Ameritech Illinois' productivity gains to customers of noncompetitive services. (Am. Ill. Ex. 1.1, pp. 83-84).

Ameritech Illinois is puzzled, however, by the suggestion in the Conclusion that the Plan met this requirement "only in part" and that, under a broader view, "there are some issues". Since these "issues" are not otherwise explained, the Company assumes that they must relate to the issues raised by CUB, which are summarized in the paragraphs in the Proposed Order preceding this Conclusion. CUB's arguments should be rejected.

CUB contended that efficiency gains did not benefit Ameritech Illinois' "captive" business and residential customers. This is untrue. Noncompetitive service customers received all of the benefits of the Company's efficiency gains to which they were entitled, and more. This is undisputed in the record.[4] CUB's only response is that increases in competitive service rates partially offset these rate reductions. However, competitive service rates are outside of the Plan. It would not be consistent with other conclusions in the Proposed Order to conclude that the Plan did not work as intended based on changes in competitive service rates. (See e.g., HEPO, Section III, 1, Commission Analysis and Conclusion, par. 8; Section V, 1, Commission Analysis and Conclusion, par. 2).

CUB also challenged Ameritech Illinois' contention that it had become more marketfocused, arguing that its achievements related primarily to promotion of vertical services. First, CUB understated the significant organizational and other changes which the Company implemented during this period. CUB also ignores the introduction of new services and new service options, such as Privacy Manager and optional calling plans. With respect to vertical features, customers like and use these services. GCI's apparent disdain for them is at odds with what is actually going on in the marketplace.

In short, GCI has not raised any issues which need to be addressed or warrant a finding that the Plan met this requirement only in part.

C. NO PREJUDICE OR DISADVANTAGE TO CUSTOMERS RESULTED FROM THE PLAN

The Proposed Order properly finds that the Plan did not prejudice any particular customer class. (HEPO, Section III, 6, Commission Analysis and Conclusions, par. 1). As the Proposed Order states, GCI made no showing of prejudice that conforms with any accepted meaning of the terms "prejudice" or "discrimination", which requires a showing of difference in treatment between similarly situated customers or customer classes. The Proposed Order goes on, however, to suggest that the term "disadvantage" has a different meaning than "prejudice" or "discrimination" and that this requirement may not have been satisfied.

There is nothing in the plain terms of Section 13-506.1(b)(7) that even remotely suggests that the words "prejudice" and "disadvantage" are to be accorded different meanings. Both of them are followed by the same reference to a "particular customer class", which clearly calls for disparate treatment of one customer class as compared to another. Thus, "disadvantage" requires the same showing of difference in treatment under the same or similar circumstances as the terms

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[4] GCI's argument that return on rate base and equity would be lower than it was at the inception of the Plan if rate reductions had exceeded Ameritech Illinois' efficiency gains is simply a variant on its earnings argument. GCI is looking at Ameritech Illinois' total jurisdictional operations, not those which are subject to the Plan.

prejudice or discrimination. If there was no showing of prejudice or discrimination -- and the Proposed Order concludes that there was none -- then there was no showing of disadvantage either.

This interpretation is supported by prior constructions of the nondiscrimination provisions in Article IX of the PUA. The terms of Section 9-241 are very similar to those of Section 13-506.1(b)(7):

> "No public utility shall, as to rates or other charges, services, facilities or in other respect, make or grant any preference or advantage to any corporation or person or subject any corporation or person to any prejudice or disadvantage"(emphasis added).

These terms describing discrimination have generally been treated as synonymous. Lowden v. Illinois Commerce Commission, 376 Ill. 225 (1941). Ameritech Illinois has found no case law which supports a finding that "disadvantage" has a different meaning than prejudice or discrimination.

Finally, the Proposed Order's substantive conclusion that the service baskets have not operated as expected is contrary to the record and inconsistent with later conclusions on the same subject. (HEPO, Section III, 6, Commission Analysis and Conclusions, par. 2). Staff's issue relative to the service baskets is that Ameritech Illinois treated optional calling plans as new services and assigned them to the "Other" basket. As the Company explained at length during the proceeding, this treatment was entirely appropriate under the terms of the Plan. Customers have complete discretion whether or not to subscribe to an optional calling plan, in lieu of basic usage rates. Thus, they are discretionary and belong in the same basket as other discretionary services, such as features. Because they offer customers choices which they did not have before, they are properly considered new services. The Company's approach is consistent with the FCC's definition of new services, which the FCC had to address under the federal price cap plan.

Treating calling plans in this manner is also necessary from an administrative perspective, because historical demand information necessary to calculate the API does not exist yet. (Am. Ill. Ex. 1.3, pp. 90-92; Am. Ill. Ex. 1.4, pp. 76-78). Indeed, in the subsequent section of the Proposed Order which specifically addresses this issue, it concludes that calling plans are properly treated as new services and are properly assigned to the "Other" basket. (HEPO, Section V, E, 2, b, Commission Analysis and Conclusion, par. 2).

Therefore, the Proposed Order's conclusion on this issue should be modified. The Commission should find that no showing of disadvantage has been made on the record of this proceeding, within the meaning of Section 13-506.1(b)(7).

III. GOING FORWARD MODIFICATIONS TO THE PLAN

A. ONLY MINOR MODIFICATIONS ARE REQUIRED IN THE PRICE INDEX

1. The X Factor Should Be 3.3%

The Proposed Order properly adopts the total factor productivity analysis supported by Ameritech Illinois and Staff as the basis for the X factor on a going-forward basis. (HEPO, Section V, B, 2, Commission Analysis and Conclusions, par. 1). However, the Proposed Order also approves inclusion of a 1% consumer dividend, above and beyond the 3.3% factor attributable to productivity gains. This component of the decision is not supported by the record and should be changed.

In extending the consumer dividend, the Proposed Order relies on Section 13-506.1(b)(5), which requires a finding that "ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvement in productivity due to technological change". Although the Commission used the consumer dividend as one way to ensure achievement of this goal in 1994, that does not mean that it should continue on a going-forward basis. In 1994, there were considerable uncertainties associated with the establishment of the Plan; the Commission had no prior experience with the establishment of a price index in general or total factor productivity analysis in particular. The consumer dividend, in effect, operated as a safety net under the X factor to ensure that consumers would properly benefit.

Circumstances in 2001 are entirely different. The Plan has now been in effect for almost seven years. The record demonstrates that the X factor was appropriately set during the first term of the Plan and that the consumer dividend was not required. In fact, as the record shows, a consumer dividend can flow through to consumers more efficiency gains than the Company can achieve -- which is precisely what happened over that period. (Am. Ill. Ex. 1.1, pp. 83-84). The X factor itself ensures that ratepayers will benefit from efficiency gains achieved over the next term of the Plan. Nothing in Section 13-506.1(b)(7) suggests that it would be appropriate as a matter of regulatory policy for consumers to receive all of the efficiency gains, much less more than what the Company actually achieves. Moreover, rates will be permanently lower over the next years of the Plan by virtue of the X factor having previously been too high. Therefore, the consumer dividend should be eliminated.

B. PRICING FLEXIBILITY SHOULD BE INCREASED

The Proposed Order rejects Ameritech Illinois' proposal to increase the pricing flexibility accorded it under the Plan. Under the existing Plan, noncompetitive rates can only be increased by the percentage change in the price index, plus 2%. Since the index has been negative by approximately 2% or more during the last six years, the Company has had essentially no flexibility to increase rates, even on a revenue neutral basis. Therefore, Ameritech Illinois proposed that some amount of flexibility be built into the Plan on a going-forward basis, and presented alternative proposals depending on whether rate rebalancing is approved. (Am. Ill. Ex. 1.1, pp. 45-48; Am. Ill. Ex. 3.0, pp. 17-19).

The Proposed Order concludes that additional pricing flexibility is not required. In support of that conclusion, the Proposed Order contends that "[t]here is little or no evidence indicating AI's non-competitive services have suffered market share losses or that it has been unable to respond to market forces". (HEPO, Section V, C, Commission Analysis and Conclusion). The Proposed Order reflects a misunderstanding of Ameritech Illinois' arguments in support of pricing flexibility and it should not be adopted.

Price regulation plans control the overall prices which the regulated company can charge for noncompetitive service. They are not designed to freeze in perpetuity the rate structures and/or rate levels which resulted from past regulatory policies. As Dr. Harris explained, well-designed price regulation plans allow gradual changes in rate structure so that the regulated company can prepare for competition, reduce subsidies, become more market oriented and generally improve allocative efficiency under its rate structure.[5] (Am. Ill. Ex. 1.2, pp. 21-22; Am. Ill. Ex. 4.0, pp. 9-10, 51-52; Am. Ill. Ex. 4.1, pp. 3-4). Ameritech Illinois further argued that to the extent rate changes can be made gradually over time (rather than in the sudden, step increases which typically result from litigated proceedings) consumers benefit. (Am. Ill. Ex. 3.3, pp. 2-3). Even if Ameritech Illinois were operating today in a monopoly environment -- which it is not -- there would be strong policy arguments for affording the Company some degree of pricing flexibility.

Thus, contrary to the suggestion in the Proposed Order, the Company never contended that it needed more pricing flexibility because "AI's noncompetitive services have suffered market share loss or that it has been unable to react to market forces". (HEPO, Section V, C, Commission Analysis and Conclusion). The Proposed Order cannot reject pricing flexibility on the grounds that the Company did not provide sufficient evidence to support a rationale that it did not advance in the first place.[6]

The Proposed Order also errs when it suggests that the only "compelling" rationale for pricing flexibility would be that residence network access line prices are below cost. (Id.). The Company recognizes that the Proposed Order accepts Staff's and GCI's concerns about the validity of the Company's cost studies. However, covering LRSIC costs is not the only issue when assessing where network access line prices need to be over the long run. Whether or not network access line prices cover their LRSIC costs -- and the Company believes that they do not -- substantially higher levels of contribution should be expected from this service to facilitate economic efficiency and competition. As the record makes clear, all services must be priced significantly above LRSIC for the Company to be financially viable. (Am. Ill. Ex. 1.2, pp. 8-14; Am. Ill. Ex. 1.4, pp. 80-81). Even on an accounting basis, the state-wide average rate of $11.81 for residence network access lines is substantially below their book cost of $19.12. (Am. Ill. Ex. 1.3, p. 147). This situation cannot continue indefinitely.

Since network access line rates have not changed since 1990, this proceeding provided the ideal opportunity to make progress towards a better rate structure. The Proposed Order recommends against doing so, because of cost study issues. As will be discussed in more detail

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5 Appropriate prices guide the consumer in making choices among available products and services. If a price is too low, excessive consumption is encouraged and resources are not allocated to the most efficient use. (Am. Ill. Ex. 4.1, pp. 2-3).

6 By this discussion, Ameritech Illinois does not mean to imply that it is not suffering residence market share losses. As Dr. Harris demonstrated in his testimony, CLECs are serving a small, but rapidly growing, number of residence customers. In addition, the use of cellular alternatives grows apace. (Am. Ill. Ex. 4.0, pp. 37-43). Moreover, the record on competition was effectively closed last December, when Ameritech Illinois filed Dr. Harris' rebuttal testimony. (Am. Ill. Ex. 4.2). Competition has continued to accelerate since then.

infra, the Company itself is withdrawing this proposal because of uncertainties created by the new legislation. Under these circumstances, it is all the more critical to provide some reasonable amount of flexibility within the context of the Plan to address rate structure problems.

The Company recognizes that reasonable people can differ over what degree of flexibility it should have under the Plan. However, the Proposed Order recommends that the Plan change not at all in this regard -- that is, that the Company have no ability to increase prices within the context of its annual price cap filings (assuming continuation of current economic conditions).[7] This excessively rigid position is not reasonable and will not serve the long run interests of consumers in this state. Therefore, Ameritech Illinois recommends that the Commission at least allow the Company to increase prices by 5% over existing levels, subject to a cap of 15% over the next five years of the Plan for any individual service. The overall financial effect, of course, would have to be revenue neutral within the context of the PCI for each basket, which means that other service rates would be reduced by an equivalent amount. The Commission would retain its existing authority to review the merit of specific pricing proposals in the annual filing process.

C. THE MERGER RELATED SAVINGS ADJUSTMENT CAN BE MADE BEFORE 2004

The Proposed Order adopts Staff's recommendation that the computation of the permanent, going forward level of net merger savings be deferred until actual data is available for the year 2003, after which time an adjustment would be made to the PCI in the April 1, 2004 price cap annual price filing. (HEPO, Section V, D, Commission Analysis and Conclusion). Ameritech Illinois agrees with the Proposed Order's conclusion that there is insufficient evidence in the record to support the calculation of a one-time merger savings adjustment to the PCI at this

[7] There is no dispute between the parties that Ameritech Illinois would be able to file rate rebalancing proposals during the term of the Plan, subject to the standard tariffing and suspension provisions of the Act. (Tr. 608-611, 2153-54).

time. The Company, however, proposes that the Proposed Order be modified to provide for the possibility of adopting a one-time adjustment to the PCI earlier than the year 2004 in the event that data regarding the actual permanent going-forward level of merger savings become available prior to 2004.

As the Proposed Order notes (HEPO, Section V, D, AI's Position, par. 1), Ameritech Illinois took the position that actual net merger savings for the year 2002 should be considered the permanent, going forward level achieved into the future. The Company proposed that a one-time adjustment to the PCI to reflect this on-going savings level be made in the April 2003 annual price cap filing. In support of its proposal to further delay the adjustment to the PCI, Staff asserted that, because approximately ninety-six percent (96%) of the going level of merger savings will have been reached by the year 2002, some savings in benefits and procurement may not be fully reflected in the year 2002 results. As the Company's witness, Mr. O'Brien, testified, however, the difference between complete realization of the going level of savings and the 96% figure used by Staff is attributable to the effect of inflation on wages and does not represent additional savings resulting from significant merger initiatives. (Am. Ill. Ex. 3.3, p. 8). Accordingly, the record supports a final computation of net merger savings on the basis of actual 2002 results. (Id., p. 7).

In its Initial Brief, Ameritech Illinois noted that, while the Company and Staff both presented long-term options that would be available to the Commission, at this juncture, there does not appear to be a consensus on the most appropriate solution or timing for the implementation of such a solution. Accordingly, the Company recommends that, on an interim basis, actual merger costs and savings continue to be examined and dealt with annually and that the permanent solution be deferred to another proceeding. Ameritech Illinois believes that this is the most appropriate approach for the Commission to take at this time because it leaves open this possibility of developing and implementing a permanent solution to the regulatory treatment of merger savings prior to the year 2004.

D. Modifications Should Be Made To The Baskets

1. The Baskets Should Be Consolidated

In its 1994 Order, the Commission established four separate baskets for Ameritech Illinois' noncompetitive services: Residence, Business, Carrier and Other (which includes discretionary residence vertical features, residence nonrecurring charges, new residence services and other miscellaneous products and services). On a going-forward basis, the Company proposed that all services which remain under the Plan be consolidated into a single basket. As a result of service reclassifications and the increased number of carrier services which are now priced strictly based on incremental cost standards, there is virtually nothing left in the Business or Carrier baskets to which the price index can or should apply. This restructure will also provide rate design benefits: that is, it will allow greater flexibility in structuring discounted service packages for customers, and it will provide a more meaningful opportunity to restructure rates across customer classes. (Am. Ill. Ex. 3.0, p. 16; Am. Ill. Ex. 4.0, p. 51).

Even if the Commission were to reject complete consolidation, the Company recommended that, at a minimum, all residence services should be consolidated in the Residence basket. (Am. Ill. Init. Br., p. 45). This modest change, combined with at least some limited pricing flexibility, would t give the Company more ability to rebalance rates within the universe of residence services in an economically rational manner. For example, today the rates for residence network access lines are in the Residence basket, while one-time installation charges associated with those lines are in the Other basket. It is generally recognized that changes in nonrecurring and recurring rates for basic residence service can have offsetting impacts on universal service and these interrelationships can be better managed within a single basket. (Am. Ill. Ex. 9.0, p. 9; Tr. 2162). Furthermore, the small number of services currently assigned to the Residence basket -- the most significant of which are network access lines, which are priced too low today -- will make future annual price cap reductions increasingly problematical. (Am. Ill. Ex. 3.3, p. 4).

The Proposed Order concludes that the four-basket structure should continue, citing concerns about improper classification of business services. (HEPO, Section V, 2, Commission Analysis and Conclusion, par. 1). The Proposed Order also finds that the four-basket structure continues to ensure that all customer classes are treated equitably. (Id.).

Ameritech Illinois urges the Commission to reconsider this recommendation in light of the recent legislation amending to the Public Utilities Act. Under Section 13-502.5 of the new Act, all business services will be classified as competitive by operation of law on June 30, 2001. Therefore, there will be no Business basket. Under these circumstances, one of the major assumptions underlying Staff's and GCI's opposition to basket consolidation -- i.e., that Docket 98-0860 would reclassify a substantial number of business services as noncompetitive -- will no longer be operative. With the complete elimination of the Business basket, the remaining three baskets should be consolidated.

Even if the Commission elects to continue the Carrier basket on a stand-alone basis, at a minimum it should adopt Ameritech Illinois' alternative proposal to consolidate the Residence and Other baskets. Even today, the Other basket contains primarily residence services. Once all business services are classified as competitive, it will only contain residential services. Since residence customers constitute one customer class, these two baskets can be consolidated without raising any issues relative to equitable treatment, discrimination or cross-subsidy.

The new legislation provides additional support for consolidating these two baskets. Under Section 13-518, Ameritech Illinois must offer three new service packages. These service packages must be configured as follows:

(1) a "budget package", consisting of one access line and unlimited local calls;
(2) a "flat rate package", consisting of one access line, unlimited local calls and the customer's choice of two vertical features; and
(3) an "enhanced flat rate package", consisting of two access lines, unlimited local calls, the customer's choice of two vertical features and unlimited local toll service.

Although Ameritech Illinois has only just begun the process of developing proposals for implementing these mandatory packages, it is apparent that the Illinois General Assembly today views network access lines, usage <u>and</u> vertical features as standard components of customer service. Otherwise, it would not have mandated the second two packages, which include vertical features. It would not be consistent with the direction provided by the legislature to continue assigning features to a separate basket.

2. <u>Certain Carrier Offerings Should Be Removed From The Baskets</u>

Ameritech Illinois excepts to the Proposed Order's recommendation that UNEs, wholesale services and carrier access charges be included within the operation of the index. The prices these services are governed by federal law and/or Commission Orders in other proceedings which established a specific TELRIC or LRSIC based pricing standard. In Dockets 96-0486/0569 (the TELRIC Order), the Commission excluded UNEs from the Plan because TA96 requires that UNE prices be set at TELRIC, plus an appropriate allocation of shared and common costs. <u>Order in Dockets 96-0486/0569</u>, adopted February 17, 1998, at p. 85. Ameritech

Illinois recommended that wholesale (resale) services and carrier access charges also be excluded from the operation of the index. Like UNEs, wholesale services are priced based on a cost standard which is established in TA96 (i.e., "avoided costs"). In Dockets 97-0601/0602, the Commission required switched carrier access rates be set at LRSIC, plus a 28.86% common overhead allocation. Order in Dockets 97-0601/0602, adopted March 29, 2000, at pp. 48-49.

The Proposed Order's analysis of the relevant legal and policy considerations is seriously flawed and should not be adopted. First, with respect to UNEs, the Proposed Order concludes that the "rates adopted by the Commission in the TELRIC Order shall be considered as price ceilings and not as price floors". (HEPO, Section V, 2, Commission Analysis and Conclusion, par. 6). The Proposed Order further contends that Ameritech Illinois is "the beneficiary of generous shared and common cost markups which AI is allowed to assess to UNEs".[8] (Id.)

The Proposed Order has seriously misconstrued the TELRIC Order. Absolutely nothing in the TELRIC Order supports the proposition that the UNE rates adopted there are price ceilings, not price floors. As the Commission clearly stated in that proceeding, the establishment of UNE prices is subject to federal law and the pricing regulations established by the Federal Communications Commission ("FCC"). Order in Dockets 96-0486/96-0569, adopted February 17, 1998, at p. 4. In connection with disputed issues relative to the relationship between wholesale and UNE rates and the so-called "sum of the parts" test, the Commission clearly stated that UNE prices are to be set at cost, as developed in that "long and arduous proceeding", and that these prices would not be subject to adjustment based on other policy considerations. In fact, in the TELRIC docket, Staff made precisely the same argument which AT&T made here for including UNEs in the price index: i.e., that the PCI adjustments provide a "valid proxy for cost changes of providing services, including UNEs". TELRIC Order, supra, at p. 81. The Commission rejected Staff's position, noting that TELRIC prices must conform to federal law which requires that prices be set at cost and, inter alia, that the price cap formula includes non-cost-based components (e.g., the consumer dividend and the service quality penalties). Id. at p. 85. Ameritech Illinois also pointed out in that proceeding that the X factor would not measure changes in TELRIC costs. Id. at 82.

None of these factors has changed one iota. No party to this proceeding has established the direct link between the price index and changes in either UNE TELRIC costs or TELRIC shared and common allocations which would be required to adjust UNE prices downward. In fact, no such link exists. As Ameritech Illinois explained, application of the price index to UNE rates, which are based on forward-looking ratemaking methodologies, mixes service cost "apples and oranges". The X factor measures changes in actual operating input and output, similar to revenue requirement or accounting-type analyses that measure productivity gains achieved in Ameritech Illinois' business, by gradually deploying newer technologies and better operating practices. In contrast, service cost studies ("LRSIC" or "TELRIC") assume that all services or unbundled elements are already provided exclusively using forward-looking technologies and forward-looking operating practices. Thus, even without the consumer dividend and service quality penalties noted by the Commission in 1998, application of the X factor to UNEs would improperly double-count productivity gains. (Am. Ill. Ex. 1.3, pp. 85-86; Am. Ill. Ex. 1.4, pp. 70-72). No party provided a convincing response to this issue. Moreover, under the terms of the Proposed Order, the price index will continue to contain non-cost-based elements like the

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[8] The Proposed Order inexplicably goes out of its way to conclude that UNEs are noncompetitive offerings. Ameritech Illinois has never contended otherwise. It is because they are noncompetitive that the Commission had to exclude them from the operation of the index in the TELRIC docket.

consumer dividend and even more stringent service quality penalties.

Under these circumstances, inclusion of the UNEs in the price index would be a violation of federal law. Under TA96, Ameritech Illinois is entitled to recover its forward-looking costs associated with the provision of UNEs. The FCC prescribed the methodology which must be used in its First Report and Order in CC Docket No. 96-98. First Report and Order in CC Docket 96-98, released August 8, 1996, ¶¶ 618-851. It is undisputed that the FCC has the jurisdiction to design a pricing methodology and that the states are obligated to follow it. AT&T Corp. v. Iowa Utilities Bd., 119 S.Ct. 721, 733 (1999).[9] Under the FCC's rules, this Commission must determine the long-run, forward-looking costs of the UNEs required by TA96. That is what the Commission did in the TELRIC docket. UNE price changes must be based on explicit and principled analyses of the costs associated with the network components and functionalities which support UNEs. The price index does not measure changes in long-run, forward-looking costs at all, much less in the TELRIC costs used to support the Company's UNE prices. Therefore, it cannot be used to require reductions in UNE rates.

The same legal constraints apply to the shared and common cost allocations to UNEs. Under the FCC's TELRIC methodology, incumbent LECs are entitled as a matter of law to recover a reasonable allocation of shared and common costs. As the FCC stated:

> "Because forward-looking common costs are consistent with our forward-looking, economic cost paradigm, a reasonable measure of such costs shall be included in the prices for interconnection and access to network elements". First Report and Order, supra, at ¶694 (emphasis added).

In the TELRIC docket, Ameritech Illinois presented an extensive analysis of its forward-looking shared and common costs which was heavily litigated. The Commission adopted this analysis with certain adjustments, which the Company implemented. The Commission also approved the

9 This issue was still in dispute at the time that the TELRIC Order was issued. TELRIC Order, supra, at p. 5.

allocation methodology. TELRIC Order, supra, at pp. 47-54. Thus, TELRIC shared and common cost allocations have exactly the same legal status as TELRIC incremental costs and neither can be unilaterally reduced based on changes in the price index.

The Proposed Order suggests that " AI is the beneficiary of generous shared and common cost markups" for UNEs. (HEPO, Section V, E, 2, Commission Analysis and Conclusion, par. 6). There is not one shred of evidence in this proceeding to support that characterization. Even a cursory review of the portion of the TELRIC Order addressing shared and common costs demonstrates that the Commission thoroughly examined Ameritech Illinois' cost studies and identified the proper shared and cost allocations under federal law. TELRIC Order, supra, at pp. 47-54. Nothing in that Order even remotely suggests that the shared and common cost amounts were "generous" and the Commission cannot so find in this proceeding.

As the Company has stated repeatedly throughout this proceeding, it is not suggesting that UNE rates are frozen indefinitely at the levels approved in the TELRIC docket. The Commission can institute an investigation into Ameritech Illinois' UNE rates at any time to determine whether the underlying, forward-looking incremental costs or the forward-looking shared and common costs have declined since 1998. In fact, in the SBC/Ameritech Merger Order, the Commission required the Company to file updated UNE studies to reflect the impact of merger savings on TELRIC costs. Order in Docket 98-0555, adopted September 23, 1999, at p. 242.[10]

Ameritech Illinois' position on wholesale rates is consistent with this analysis. Again, wholesale rates are established based on a standard (i.e., "avoidable costs") specified in TA96, using a methodology developed by the FCC and implemented by this Commission. Order in

[10] The Commission has yet to institute any investigation into these cost studies.

Dockets 95-0458/0531, adopted June 26, 1996. Ameritech Illinois is entitled to set its wholesale rates based on this standard and nothing in TA 96 contemplates further reductions. The Proposed Order states the legal requirements backwards when it contends that "nothing in the Federal Act precludes further reductions to wholesale rates". (HEPO, Section V, E, 2, Commission Analysis and Conclusions, par. 8). Since TA96 prescribes the standard which the incumbent LEC is entitled to use in setting its prices, specific statutory authorization is required to force the LEC to charge less than that. No such authority exists in the context of this proceeding. Separate application of the price index is unnecessary in any event, because wholesale rates must decline with their retail counterparts. (Am. Ill. Ex. 1.3, p. 87).

The Company's position with respect to carrier access rates differs only in the fact that it is based on state law alone. In Dockets 97-0601/0602, the Commission required that switched carrier access rates be set at LRSIC, plus a 28.86% common overhead allocation. Order in Dockets 97-0601/0602, adopted March 29, 2000, at pp. 48-49. Further downward adjustments based on the price index would result in carrier access rates which are below the level which the Commission found to be reasonable and equitable. (Am. Ill. Ex. 3.0, p. 15; Am. Ill. Ex. 1.3, p. 85; Am. Ill. Ex. 1.4, pp. 71-72). The Company does not dispute the fact that the Commission's Order in that docket described the 28.86% overhead allocation as a "maximum", as the Proposed Order states. (HEPO, Section V, E, Commission Analysis and Conclusion, par. 7). However, this begs the question of how a different treatment of shared and common costs could be mandated. The 28.86% allocation was based on record evidence in the Access Charge Reform Order. Although the Company has discretion to charge less if it chooses to do so under the "maximum" standard, the Commission can only base further reductions on substantial evidence that Ameritech Illinois' shared and common costs have changed and/or that the price index accurately measures such changes. No such evidence was presented by AT&T or GCI. Ameritech Illinois further notes that the SBC/Ameritech Merger Order also required the Company to file updated access charge cost studies, to reflect merger savings on a forward-looking basis. Order in Docket 98-0555, supra, at p. 242. This would be the proper context in which to address changes in access charge levels.[11]

E. MONITORING AND REPORTING REQUIREMENTS SHOULD BE STREAMLINED

Extensive annual monitoring and reporting requirements were imposed by the 1994 Order, as shown in the Proposed Order. (HEPO, Section V, G, par. 4). The Commission has now had six years experience with the Plan. Ameritech Illinois maintained that these existing requirements can be streamlined on a going-forward basis to reduce the costs of regulation, without any loss in appropriate oversight capabilities.

Ameritech Illinois excepts to the Proposed Order's conclusion that they should all be maintained. (HEPO, Section V, G, Commission Analysis and Conclusion). Even the Proposed Order acknowledges that in some instances these reporting requirements are "duplicative". (Id.) At a minimum, these duplicative requirements should be eliminated.

IV. SERVICE QUALITY - GOING FORWARD

A. THE PROPOSED ORDER WOULD UNREASONABLY INCREASE SERVICE QUALITY PENALTIES.

The Proposed Order correctly concludes that the Plan has, for the most part, succeeded in maintaining service quality. (HEPO, Section III, 9, Commission Analysis and Conclusions, par. 4). However, despite that finding, the Proposed Order would increase service quality penalties enormously. In fact, the Proposed Order would more than triple the base penalty for missing one

[11] The Commission has yet to institute any investigation into these cost studies either.

of the Commission's benchmarks, from approximately $2.6 million under the current Plan (GCI Ex. 2.0, p. 57) to $8 million in 2002. The base penalties would then double again over the next four years, to $16 million per miss (or more than six times the current base penalty) by 2006. Finally, the Proposed Order would impose additional penalties of $2 million for missing any benchmark by more than 5%, $4 million for missing any benchmark by more than 10%, and another $2 million for missing any of the benchmarks in consecutive years. (HEPO, Section VII, F, Commission Analysis and Conclusions, pars. 12-13).

Moreover, those increases would apply even to those measures for which it is undisputed that Ameritech Illinois successfully maintained the quality of service. For example, Staff witness Jackson testified that "the $4 million [.25 percent] rate reduction for each of these standards was enough incentive for the company to meet the standards." As a result, she recommended that the same penalties be maintained (at least if service quality remained a factor in the price cap calculation). Moreover, given that those penalties have generally been adequate in the past, Ms. Jackson testified that the same penalties should be applied to Staff's proposed new service quality measures (again within the price cap calculation). (Staff Ex. 9.0, p. 45). Ms. Jackson is clearly correct. To the extent the existing penalties have proven adequate, there is no reason to increase them.

Similarly, GCI's only argument for increasing service quality penalties is that the existing penalties allegedly have not been sufficient to maintain service quality. For example, Ms. TerKeurst argued that because (in her view) existing penalties "failed to motivate Ameritech Illinois to provide adequate service quality," the Commission "should strengthen the financial consequences that Ameritech Illinois will incur whenever it fails to provide high quality service to its customers." (GCI Ex. 2.0, p. 57). Once again, however, as both Ms. Jackson and Mr.

Hudzik recognized, this argument cannot support increased penalties for service quality measures that have not presented any significant problems. (Am. Ill. Ex. 12.1, pp. 33-34; Staff Ex. 9.0, p. 45).

There is simply no question that the existing Plan—including the existing penalty structure—has succeeded in maintaining service quality for most measures. Most obviously, no one questions that Ameritech Illinois has successfully met the Commission's annual service quality benchmark for six of the eight current benchmarks in every single year of the Plan. Three of those six would be included in the new Plan: Trouble Reports per 100 Access Lines, plus Operator Speed of Answer (Toll, Assistance and Information, on a combined basis). However, the Proposed Order would impose increased penalties for those measures, without any evidence at all that the existing penalties have failed to ensure that service quality would be maintained. In fact, it is clear that service quality has improved substantially over the life of the Plan for each of those measures. (Am. Ill. Ex. 12.1, pp. 6-8).

Similarly, the Proposed Order would impose increased penalties on each new service quality measure, although there is no evidence that increased penalties are necessary to assure compliance with those measures. (<u>See</u> Am. Ill. Ex. 12.1, pp. 33-34; Staff Ex. 9.0, p. 45). For example, Ameritech Illinois' performance for repair repeat reports has generally been superior to that of the industry as a whole, based on federal ARMIS reports. (Am. Ill. Cox Cross Ex. 7). Similarly, Ameritech Illinois has promptly devoted the resources necessary to assure compliance with the Commission's new benchmarks (effective October 2000) for business and repair office answering times. (Am. Ill. Ex. 12.1, p. 3).

Aside from the parties' disagreements regarding OOS>24 and Installation Within Five Days, there is simply no evidence that Ameritech Illinois has failed to maintain service quality for any measure, so there is also no evidence that increased penalties are either necessary or appropriate. (See Am. Ill. Ex. 12.1, pp. 33-34; Staff Ex. 9.0, p. 45). And, even regarding OOS>24 and Installation Within Five Days, the record shows that increased penalties are neither necessary nor appropriate.

Regarding OOS>24, the Company's conduct since 1999 demonstrates that the existing penalties (including the $30 million merger penalty) are adequate to maintain reasonable performance. During 1999, the Commission imposed an additional $30 million dollar penalty for OOS>24. As shown by the very significant improvement in 00S>24 performance since that penalty was adopted, this incentive has been adequate to insure the Company strives to meet the benchmark. (Am. Ill. Ex. 12.1, p. 35). Ameritech Illinois failed to meet this benchmark in 2000 only because of the unforeseen headcount losses that compromised installation and repair service generally—a problem separate from inadequate penalties. That problem was promptly addressed by significant force additions in the Network organization. Those force additions demonstrate a strong commitment to deliver the required level of service without further increases in penalties. (Id., pp. 34-35).

With respect to Installation within Five Days, the Proposed Order properly recognizes that that the Company has been reporting this measure in the same way as it always has, consistent with the manner used when the original benchmark was developed. As the Proposed Order finds, "the existing benchmark was calculated from data that included vertical services". (HEPO, Section VII, D, 1, Commission Analysis and Conclusions, par. 1). On that basis, the Company has, without question, met this benchmark consistent over the life of the Plan. To increase this penalty when the Company has never missed the current benchmark would be both unfair and inconsistent with the testimony of all the parties—that penalties should be increased only if it can be shown that the existing penalties are inadequate. (Am. Ill. Ex. 12.1, pp. 33-35; see Staff Ex. 9.0, p. 45; GCI Ex. 2.0, p.57).

B. THE COMMISSION'S ORDER SHOULD REFLECT THE IMPACT OF SECTION 13-712 OF H. B. 2900

As the Hearing Examiner, the Commission and the parties are well aware, the General Assembly has recently amended the Public Utilities Act, subject to the Governor's signature. Among the new provisions is Section 13-712, which addresses service quality. Section 13-712 significantly expands the Commission's authority over retail service quality issues. Section 13-712 requires that the Commission promulgate service quality rules including remedies for installation or repair delays and for missed installation or repair appointments. The remedies include both customer credits and, for extended delays, the provision of alternative service. The remedies provided in Section 13-712 are broader and more severe than those proposed in the Proposed Order, primarily (although not exclusively) in three ways: (1) customer credits would be provided for missed appointments, (2) customer credits would not be capped (and are, therefore, likely to exceed the value of the relevant service in many cases), and (3) customers subject to extended delays could choose alternative telephone service in lieu of credits. H.B. 2900 § 13-712(d)-(e).

The Proposed Order correctly recognizes that, as a matter of fairness, the Commission should "avoid a double penalty" for those measures for which customer-specific remedies are provided. As a result, the HEPO proposes that Ameritech Illinois be allowed to deduct the customer credits (and associated administrative expenses) from any annual penalties under the Plan. (HEPO, Section VII, F, Commission Analysis and Conclusion, par. 17). That conclusion is clearly correct. However, in light of Section 13-712, the Proposed Order's conclusion should be modified to reflect both the broader scope and the increased stringency of the remedies that will be imposed under the Commission's new rules.

Section 13-712 reflects the General Assembly's judgment regarding the appropriate level of customer credits for each of the four service quality measures specifically addressed by the new law (OOS>24, Installation within Five Days, Missed Installation Appointments and Missed Repair Appointments). Moreover, once the Commission has completed the rulemaking process, the resulting rules will also reflect the Commission's judgment regarding appropriate remedies for any other measures for which remedies might be adopted. Thus, customers will be fully compensated under Section 13-712 and the Commission's resulting rules with respect to any service quality measure for which such remedies are provided. At that point, additional penalties under the Alternative Regulation Plan will no longer be necessary, nor would they make good policy.

As the Proposed Order properly recognizes, "Our aim is to promote efficient investment in compliance." (HEPO, Section VII, F, Commission Analysis and Conclusions, par. 2). Additional penalties beyond those adequate to fully compensate customers could not reasonably be described as promoting "efficient investment in compliance." As courts throughout the country have long recognized, in a commercial relationship, efficiency and social welfare are best promoted by limiting remedies to those necessary to compensate the aggrieved party. Absent wrongful conduct that would independently create a right to additional remedies (such as fraud, malice or gross negligence), additional penalties are both inefficient and inappropriate. See, e.g., Patton v. Mid-Continent Systems, Inc., 841 F.2d 742, 750-51 (7^{th} Cir. 1988); Allapattah Services, Inc. v. Exxon Corp., 61 F. Supp. 2d 1326, 1329-30 (S.D. Fla. 1999).

As a result, once the Commission's new service quality rules pursuant to Section 13-712 have become effective, any service quality measures for which customer compensation is provided through those rules should be eliminated from the Alternative Regulation Plan. Given that customers will be adequately compensated under those rules, any additional remedies would be excessive, both as a matter of law and as a matter of policy. In the alternative, at a minimum, such payments (including administrative expenses) should be deducted from any annual penalties that would be paid under the Plan, as currently provided by the Proposed Order. (HEPO, Section VII, F, Commission Analysis and Conclusions, par. 17).

C. THE PROPOSED ORDER'S BENCHMARK FOR INSTALLATION WITHIN FIVE DAYS IS ARBITRARY AND CAPRICIOUS AND IS NOT SUPPORTED BY RECORD EVIDENCE.

The Proposed Order correctly finds that Ameritech Illinois has always included vertical service orders and that, as a result, the existing benchmark is based on data that included vertical service orders. As the Proposed Order concludes, "the existing benchmark was calculated from data that included vertical services and we have no definitive evidence on the extent of the growth before or during the Plan term . . . . Therefore, consistent with our treatment of OOS>24 in the 1994 Order, we will adopt the Part 730 standard as the benchmark for this measure." (HEPO, Section VII, D, 1, Commission Analysis and Conclusions, par. 1). That conclusion is clearly correct.

Next, however, the Proposed Order includes a finding that is directly contrary to that conclusion, its reasoning and all of the evidence in the record: "We will, however, require an escalation of 1% every 6 months until the benchmark reaches the desired 95.44%." (Id.). The second conclusion simply does not follow from the Proposed Order's previous, correct conclusion that Ameritech Illinois' installation data has always included vertical service orders.

Given the Proposed Order's primary conclusion, as well as the clear record evidence that supports it, the benchmark figure of 95.44% is completely meaningless once the benchmark itself has been redefined to exclude those orders.

The express goals of Section 13-506.1 of the Act, the 1994 Order and the Proposed Order are to "maintain" service quality. As a matter of plain English, "maintain" means "to keep in an existing state." (Am. Ill. Ex. 3.1 at pp. 2-3 quoting Webster's Ninth New Collegiate Dictionary 718 (1989)). As the Commission has previously ruled, this means a level of service that reflects either a historical level of performance or an existing standard imposed by the Commission's rules. 1994 Order at p. 58. The Proposed Order's ultimate benchmark of 95.44%, defined to exclude vertical service orders, reflects neither. As a result, the Proposed Order's proposal to ratchet the installation benchmark upward to 95.44% is inconsistent with the Act, the 1994 Order, and the primary finding of the Proposed Order itself, and it should therefore be eliminated. The benchmark should instead be established at 90% on a going-forward basis.

D. THE PROPOSED ORDER'S ADOPTION OF STAFF'S PROPOSED BENCHMARK FOR MISSED REPAIR COMMITMENTS IS UNEXPLAINED AND INCONSISTENT WITH ITS OTHER FINDINGS.

The Proposed Order generally adopts Ameritech Illinois' position that five years of data should be used to calculate service quality benchmarks. The Proposed Order finds that "as a general proposition, we believe that using five years of data better accounts for year-to-year and seasonal variations in conditions that affect service quality performance." (HEPO, Section VII, C, Commission Analysis and Conclusions, par. 3). That finding is correct. All else equal, more data is clearly better than less data. (Am. Ill. Ex. 3.4, pp. 14-17; Am. Ill. Ex. 12.1, pp. 21-22). Consistent with that finding, based on historical performance for the years 1995-99, the Commission should adopt a benchmark of 9.58% for Missed Repair Commitments (Field Visit).

(Am. Ill. Ex. 3.4, p. 16). The Proposed Order, however, adopts Staff's proposed benchmark of 6.4%, based on performance for 1998-99—a benchmark Staff did not propose until its Reply Brief. (HEPO, Section VII, D, 7, Commission Analysis and Conclusions, par. 1). The Proposed Order's conclusion is flawed for several reasons.

First, as noted, the conclusion is inconsistent with the previous ruling that "as a general proposition . . . using five years of data better accounts for year-to-year and seasonal variations in conditions that affect service quality." (HEPO, Section VII, C, Commission Analysis and Conclusions, par. 3). Moreover, the Proposed Order's departure from that finding is entirely unexplained. Except that the Proposed Order's conclusion results in a far more stringent benchmark than would otherwise be adopted, the Proposed Order does not even hint at a reason for rejecting the use of five years of data for this benchmark. As a result, the Proposed Order's conclusion on this issue, if adopted, would be erroneous. 220 ILCS 5/10-201(e)(iii).

Second, a review of the available data shows that the 1998 and 1999 data do <u>not</u> reasonably reflect year-to-year variations in this measure. Annual performance for Missed Repair Commitments (Field Visit), from 1995 through 1999, was as follows:

1995:	14.39%
1996:	12.47%
1997:	7.97%
1998:	6.70%
1999:	6.35%

(Am. Ill. Ex. 3.4, p. 16). While Ameritech Illinois' proposed benchmark of 9.58% falls very close to the center of the range, Staff's proposed benchmark of 6.40% falls at the extreme lower end of the range—only .05% above the best annual performance ever. As a result, the proposed benchmark obviously does not account for "year-to-year and seasonal variations in conditions that affect service quality" (HEPO, Section VII, C, Commission Analysis and Conclusions, par. 3), and it should therefore be rejected.

Finally, regardless of whether Staff's or Ameritech Illinois' proposed benchmark is adopted, the Commission should make clear that it is not adopting the new definition that Staff proposed for this measure, for the first time, in its Reply Brief. According to Staff, this measure should reflect the number of repair visits for which work is completed both within the time committed and within 24 hours. (Staff Reply Br., p. 58).[12] Staff's proposed new definition is inappropriate for several reasons. Most fundamentally, Staff's proposal is, in effect, a "bait and switch." Having advocated a measure and benchmark based on Ameritech Illinois' existing practices, Staff now proposes to change the definition at the eleventh hour. In addition, the proposed change would distort the purpose of this measure—which is to measure Ameritech Illinois' ability to complete work at the time the customer expects it to be completed, not to complete work within any specific period of time. (Am. Ill. Ex. 12.0, pp. 28-29). Ameritech Illinois' ability to complete repairs generally within 24 hours is already measured separately, through the OOS>24 benchmark. That is not the purpose of this measure, which is intended to measure reliability rather than speed.[13] To make clear that Staff's definition is not being adopted, the Proposed Order should explicitly state that this benchmark, like all others, should be defined in a manner consistent with the underlying data.

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[12] Ameritech Illinois does not understand the Proposed Order, as written, to adopt Staff's position on this issue, for two reasons: (1) the Proposed Order does not address the issue, and (2) Staff's position is inconsistent with the data upon which the proposed benchmark is based. Nevertheless, for clarity, Staff's proposal should be expressly rejected.

[13] Meeting commitments is an important aspect of customer service, entirely independent of the time required to complete a given repair. Customers have an interest in being able to count on repairs being completed within the time committed, regardless of the time required to do the work. For example, if a particularly complex repair will unavoidably take more than 24 hours, the customer will still be interested in knowing when the repair will be completed. Similarly, many field visit repair commitments will require the customer to provide access to the premises to perform the work. In those circumstances, appointments outside the 24-hour window will often be arranged at the customer's request. Once again, the customer is interested in reliability, not just speed.

E. <u>THE COMMISSION SHOULD REJECT THE PROPOSED MEASURE AND BENCHMARK FOR "CALLS ANSWERED."</u>

The Proposed Order directs the parties to "better explain the measure, benchmark and their respective positions in their Exceptions." (HEPO, Section VII, D, 10, Commission Analysis and Conclusions, par. 1).

As a preliminary matter, it may be useful to define Calls Answered (or Calls Abandoned). Calls Answered reflects the percentage of customer calls to the Company's business or repair offices which are completed, rather than being abandoned by the customer before the call has been answered. As Ms. TerKeurst testified, Calls Answered is simply the converse of Calls Abandoned. For example, if 90% of calls are answered, then 10% are abandoned. As a result, the two measures are completely interchangeable. (GCI Ex. 2.0, p. 38).

Ms. TerKeurst proposed a measure and benchmark for Calls Answered in her direct testimony. (GCI Ex. 2.0, pp. 38-40). Staff initially took essentially the same position. Ms. Jackson, in her direct testimony, proposed two measures of Calls Abandoned, for Customer Care Centers (Residence and Business combined) and Repair, respectively. (Staff Ex. 9.0, pp. 24-25).

Ameritech Illinois opposed those measures. As Mr. Hudzik explained, in Docket 98-0453, the Commission rejected Staff's proposal to include measures for abandoned calls in the Part 730 rules. (Am. Ill. Ex. 12.0, pp. 31, 44). In that proceeding, the Commission concluded, "measurement of abandoned calls is imprecise and the Commission declines to impose a measurement of abandoned calls at this time." <u>Order in Docket 98-0453</u>, adopted February 9, 2000, at p. 8 (the "<u>Service Quality Order</u>"). As Mr. Hudzik explained, "Abandoned calls are at best an indirect measure of answering performance. . . . Why use a less direct and less accurate measure when you can measure answering performance directly?" (Am. Ill. Ex. 12.0, p. 31).

In response to Ameritech Illinois' argument, Ms. Jackson agreed in her rebuttal testimony that the Commission should not adopt a measure for the percentage of calls abandoned. (Staff Ex. 23, pp. 13-14). As the Proposed Order correctly notes, she testified that "Staff is prepared to accept replacement of the abandon rate with an answering time standard." She agreed that "answering time will provide the Staff with the information needed" to maintain answering performance. (Staff Ex. 23, pp. 13-14).

Staff changed its position again in its Reply Brief. There, Staff proposed a single measure for Calls Answered, reflecting both business and repair office answering. (Staff Reply Br., pp. 60-61). While Staff argues that its new position is consistent with Ms. Jackson's testimony (Staff Reply Br., p. 60), it clearly is not. Ms. Jackson testified that "Staff is prepared to accept replacement of the abandon rate with an answering time standard." (Staff Ex. 13, p. 13 (emphasis added)). Obviously, the percentage of calls answered (or abandoned) does not measure "answering time". Moreover, even if it did, Staff's new position makes nonsense of Ms. Jackson's rebuttal testimony. Why would Ms. Jackson have abandoned her original proposed measure, Calls Abandoned, only to propose a measure for Calls Answered? They measure exactly the same thing. (See GCI Ex.2.0, p. 38).

In any event, the Commission has already addressed this issue, and neither GCI nor Staff has given the Commission any reason to reconsider it. As the Commission ruled only a little more than a year ago, "measurement of abandoned calls is imprecise and the Commission declines to impose a measurement of abandoned calls at this time." Service Quality Order at p. 8. The Commission should continue to measure answering time performance directly, and it should again reject any measure of calls answered or abandoned.

F. THE COMMISSION SHOULD REJECT ANY MEASURE FOR INSTALLATION REPEAT REPORTS OR, IN THE ALTERNATIVE, SHOULD CORRECT THE PROPOSED BENCHMARK.

Ameritech Illinois continues to oppose the adoption of any measure for installation repeat reports. However, if such a measure is included in the Plan, Ameritech Illinois wishes to correct an error in the calculation of the relevant benchmark, which appears in the Proposed Order as a result of an error in Ameritech Illinois' Reply Brief. (HEPO, Section III, D, 5, Commission Analysis and Conclusion, par. 1).

First, Ameritech Illinois continues to oppose the adoption of a measure and benchmark for installation repeat reports. As Ameritech Illinois explained in its Initial Brief (pp. 83-84) and its Reply Brief (pp. 48-49), Ameritech Illinois does not generally believe that repeat reports for either installation or repair need to be included in the Commission's service quality measures; however, customers are more sensitive to repair repeats, because they have already experienced one instance of trouble. (Am. Ill. Ex. 12.1, pp. 29-30). Therefore, Ameritech Illinois has agreed to include repair repeat reports, but not installation repeat reports, in the Plan. (Am. Ill. Ex. 12.0, pp. 27, 45).

Second, however, if the Commission does adopt such a measure, Ameritech Illinois wishes to correct an error that appears in the Proposed Order as a result of a mistake in Ameritech Illinois' Reply Brief (p. 49). In that brief, Ameritech Illinois explained that installation and repair repeats are separate measures that cannot be combined; thus, Staff's proposal would need to be modified by splitting a single penalty between installation and repair repeats, with separate benchmarks for each. That approach was adopted by the Proposed Order, and that approach remains the correct one if an installation repeat measure is adopted.

However, Ameritech Illinois misinterpreted GCI Exhibits 2.1 and 12.1, which provide data for various measures of service quality. Ameritech Illinois incorrectly argued that the data identified in those exhibits as "POTS % Installation Trouble Reports" did not correspond with Staff's proposed measure for Installation Repeat Reports. (Am. Ill. Reply Br., p. 49). Ameritech Illinois has since reviewed the exhibits and determined that the data identified as "POTS % Installation Trouble Reports" are in fact the proper data from which to calculate a benchmark for Staff's proposed measure. The data are available only for 1998, 1999 and part of 2000. Consistent with the general approach of the Proposed Order, a benchmark would be based on the data for 1998 (4.63%) and 1999 (4.13%), the only years for which complete data are available. As a result, the benchmark for this measure, if such a benchmark were adopted, should be 4.41%, based on historical data for 1998 and 1999. (GCI Ex. 12.1, p. 4).

V. RATE REBALANCING.

In this proceeding, Ameritech Illinois proposed to rebalance rates by increasing the monthly charge for residence network access lines by $2 per month across all access areas, while reducing other service rates to make the plan revenue neutral. The Proposed Order rejects the Company's rate rebalancing proposal. (HEPO, Section IV, Commission Analysis and Conclusion). As the sole basis for this decision, the Proposed Order takes issue with the Loop Facility Analysis Model ("LFAM"), used by the Company to develop investments for the feeder, distribution and drop portions of the local loop for purposes of calculating network access line LRSICs. The Proposed Order concludes that, based on alleged problems with the LFAM, the Company "has failed to meet its burden in convincing the Commission that its costs for network access lines are above LRSIC" [sic].[14] Ameritech Illinois takes exception to this conclusion.

[14] The Company interprets this statement as concluding that the Company failed to meet its burden of proving that current prices for residential network access lines are below cost.

A. THE COMPANY HAS DECIDED TO WITHDRAW ITS RATE REBALANCING PROPOSAL IN LIGHT OF THE RECENT ILLINOIS TELECOMMUNICATIONS LEGISLATION.

As previously discussed, Section 13-518 of H. B. 2900 will require Ameritech Illinois to offer certain flat rate local service packages to residential customers. The required introduction of flat rate service represents a significant change in the Company's existing rate structure which, in accordance with Commission policy, has reflected mandatory measured local service since the 1980s. The Company is beginning the process of developing rate packages designed to meet the requirements of Section 13-518. At this time, however, it is uncertain what impact Section 13-518 and the flat rate packages ultimately approved by the Commission will have on the Company's rate structure in general, and the rate rebalancing proposal in particular. Until it has had an opportunity to fully assess that impact, the Company has determined that it would be prudent to, and hereby does, withdraw its rate re-balancing proposal.

B. THE PROPOSED ORDER'S CONCLUSIONS REGARDING THE LFAM ARE UNSUPPORTED BY ADEQUATE FINDINGS AND ANALYSIS AND ARE CONTRARY TO THE EVIDENCE.

For the reasons discussed below, the Proposed Order's statements regarding the LFAM are unsupported by adequate findings and are contrary to the evidence. The Proposed Order should be modified to approve the LFAM and the LRSIC studies presented by the Company in this case. At a minimum, the Commission should eliminate the Proposed Order's statements criticizing the LFAM because those statements are unsupported by the evidence and unnecessary in light of the Company's decision to withdraw its rate rebalancing proposal.

1. The LFAM Results In An Accurate Estimate Of The Company's Network Access Line Costs.

The Proposed Order's criticism of the LFAM stems from the fact that use of the LFAM resulted in increases in the LRSICs calculated for network access line ("NAL") service over the

LRSICs reported in the Company's last Aggregate Revenue Test ("ART") filing. The LFAM, however, reflects significant improvements over the old loop cost model which was used in preparing the ART filing. The Company's cost-of-service expert, Mr. Palmer, described those improvements in detail and explained how those improvements result in a more accurate estimate of the Company's NAL costs. (Am. Ill. Ex. 10.0, pp. 28-29; Am. Ill. Ex. 10.1, pp. 41-46).

As Mr. Palmer explained, for example, the previous model relied on 1600 samples that were over ten years old to develop distribution and drop investments. The new model uses 5.2 million addresses in almost 12,000 distribution areas. The new model also captures necessary component costs that were not included in the old samples, such as Service Area Interfaces and interior terminals and drops. As Mr. Palmer also explained, the algorithm for computing the investment per working circuit was revised in the LFAM to properly recognize that cables are only available in a limited number of sizes. (Am. Ill. Ex. 10.1, p. 44). The new model also reflects a mix of 22-, 24-, and 26- gauge cable, which is the forward-looking mix actually being deployed by Ameritech Illinois. The old model assumed that all cable was 26-gauge, which is the smallest and least expensive gauge. In addition, the old loop cost model did not include investments for the huts and cabinets that house terminal equipment. (Am. Ill. Ex. 10.1, pp. 28-29; Am. Ill. Ex. 10.2, pp. 42-45).

As Mr. Palmer also testified, not all of the LFAM improvements resulted in an increase in costs. For example, the LFAM reflects fiber cable investments that are lower than the investments reflected in the old loop cost model. The LFAM also includes more of the less expensive fiber circuits than the previous model because the economic breakpoint at which it is less expensive to deploy fiber facilities was reduced from 12,000 feet to 6,000 feet. In addition, the new model reflects a greater variety of Digital Loop Carrier ("DLC") equipment sizes, which results in less unused capacity and less expensive DLC components. (Am. Ill. Ex. 10.1, p. 46).

As a result of these and other LFAM improvements described by Mr. Palmer, the cost studies under review in this proceeding resulted in a more accurate estimate of the Company's network access lines costs. (Am. Ill. Ex. 10.1, pp. 28-29; Am. Ill. Ex. 10.2, pp. 42-45). The Proposed Order contains no finding or analysis to refute this conclusion. In fact, the testimony of Mr. Palmer explaining and justifying the improvements in the LFAM was unrebutted. Accordingly, the fact that network access line LRSICs are higher than previous estimates of LRSICs calculated using a less accurate loop cost model does not support rejection of the LFAM and the resulting LRSICs.

2. <u>The Proposed Order's Vague References To Staff And City Of Chicago Arguments Do Not Support Its Conclusions Regarding The LFAM.</u>

The Proposed Order suggests that it agrees with Staff and the City of Chicago that there are some "deficiencies" in the LFAM and that the LFAM may not comply with certain requirements of the Commission's Cost of Service Rule (the "Rule") (83 Ill. Admin. Code Part 791). The Proposed Order, however, does not explain precisely how the LFAM is "deficient." The Proposed Order also does not identify which provisions of the Cost of Service Rule are violated by the LFAM or how those provisions are violated. While the Proposed Order provides synopses of Staff and City arguments in the Sections entitled "Staff's Position" and "City/CUB Position," respectively, it is unclear which of the Staff and City arguments were ultimately relied upon by the Proposed Order as support for its conclusions regarding the LFAM.

Moreover, to the extent that Staff has any specific concerns regarding the LFAM, it did not identify or support those concerns in a manner to which the Company or the Commission can respond in any meaningful way. Staff's approach was to summarily "reject" the LFAM without offering any constructive criticism, or suggestions for improvement, of the model. The Proposed Order identifies a number of arguments made by Staff in support of Staff's "rejection" of the LFAM. (HEPO, Section IV, Staff's Position, par. 2). However, these arguments are extremely general in nature and were made for the first time in Staff's rebuttal testimony. Each of those arguments was fully refuted by Mr. Palmer in his surrebuttal testimony. (Am. Ill. Ex. 10.2, pp. 2-29). Staff, however, made no attempt whatsoever to address Mr. Palmer's responses to the Staff arguments. Indeed, the only substantive discussion in Staff's Initial Brief related to any aspect of the Company's LRSIC studies was Staff's argument that the overall cost of capital for LRSIC purposes is 10.75%, a rate higher than the cost of capital used in the Company's studies. (Staff Init. Br., pp. 119-22). In its Reply Brief, Staff argued that the LFAM should have reflected a fiber/copper breakpoint of 12,000 feet, rather than 6,000 feet. Staff, however, failed to even address, much less refute, Mr. Palmer's testimony that the adoption of Staff's position on this point would actually result in an increase in the LRSICs for network access lines. (Am. Ill. Ex. 10.2, p. 26).

The Company has devoted a substantial amount of time, effort and expense to developing the LFAM. As previously discussed, the LFAM represents a significant improvement over the loop feasibility investment model which the LFAM replaces. It is neither fair nor constructive for the Commission to summarily reject the LFAM based on Staff's vague, generalized and unsupported criticisms. The Commission should, consistent with the evidence, approve the LFAM. If the Commission does not affirmatively approve the LFAM in the Order in this case, the Commission should, at a minimum, (i) eliminate the Proposed Order's findings regarding the

LFAM; and (ii) direct Staff to work cooperatively with the Company to address and resolve any specific concerns which Staff continues to have after considering Mr. Palmer's testimony.

The Proposed Order is incorrect in stating that the "City lists no less than seven deficiencies with AI's LFAM," an apparent reference to arguments summarized in the second paragraph of the subsection of Part IV entitled "City/CUB Position." In fact, only one of the referenced arguments (that the LFAM "failed to use 'Least Cost Currently Available' technology") relates to the LFAM. As will be discussed, that argument was made for the first time by the City in its Initial Brief on the basis of extra-record mischaracterizations of the facts and is wholly devoid of merit. The rest of the City of Chicago's arguments have nothing to do with the validity or reliability of the LFAM.

For example, the Proposed Order states that the City argued that the "AI LFAM failed to address what the City calls a line mix assumption." In fact, the "line mix assumption" issue involved a dispute between the Company and the City over certain values to be assigned in applying the Ameritech Regional PIP Switching Model ("ARPSM"), the model used to calculate forward-looking switching investments. Similarly, what the Proposed Order characterizes as arguments made by the City regarding "AI use of 'Cost of Capital'" and an "inflated 'net investment'" do not relate to the LFAM. Rather, those arguments concern the appropriate application of the Economic Costs of Network Services/Capital Costs ("ECON/CAPCOST") model which is used to convert capital investments determined by the LFAM and ARPSM models to annual charges (consisting of depreciation, cost of capital and income taxes) associated with those investments. As will be discussed, none of the City's arguments (including those which have nothing to do with the LFAM as well as the one unsupported argument that does) have merit and none of those arguments support rejection of the LFAM. Staff did not take issue with the ARPSM, ECON/CAPCOST model or any aspect of the Company's Cost Analysis other than the LFAM.

Finally, Ameritech Illinois takes exception to Section of the Proposed Order entitled "AI's Response" because it fails to mention the extensive evidence presented, and arguments made, by the Company, in direct response to each of the Staff and City of Chicago arguments about the LFAM and other aspects of the Company's LRSIC studies.

3. Staff's Arguments Are Unsupported By The Evidence And Do Not Support Rejection Of The LFAM.

The Proposed Order's references to Staff's arguments do not support a rejection of the LFAM. As previously indicated, Mr. Palmer's testimony responding to each of Staff's generalized criticisms of the LFAM stands unrefuted on the record in this case. Each of Staff's arguments, as summarized in the second paragraph of the subsection entitled "Staff's Position" of Section IV of the Proposed Order, is addressed more fully below:

- *"Staff notes with skepticism that AI's new LFAM shows costs increasing dramatically while at the same time industry costs are declining."*

Staff's argument misrepresents the results of the LFAM. As Mr. Palmer explained, the LFAM does not show that the actual costs of network access lines have "increased dramatically." Rather, cost model improvements and more realistic input assumptions have resulted in higher, yet more realistic, estimates of Ameritech Illinois' access line costs. This is because the previous cost studies omitted many actual costs and underestimated other costs. (Am. Ill. Ex. 10.2, p. 29).

- *"Staff points out that this Commission has never approved a cost study generated by, or costs allowed from, the LFAM model."*

This argument does not logically or lawfully support rejection of the Company's cost studies. Because the LFAM is a new model, the Commission has not previously had an opportunity to approve a "cost study generated by, or costs derived from the LFAM model."

Staff's argument suggests that the Commission should reject out of hand any proposals based on improvements to previously approved cost models. That argument is untenable as a matter of law and sound regulatory policy.

- *"Staff is not persuaded by AI's argument that its new model is able to identify and recover costs that prior models failed to identify and recover."*

The law does not impose on Ameritech Illinois the burden of persuading Staff, or any other party, to accept its position. As previously discussed, Mr. Palmer presented extensive evidence describing the improvements reflected in the LFAM model and explaining how those improvements result in a more accurate estimate of network access line costs. Staff did not rebut that evidence. The Company more then met whatever burden it had of persuading the Commission to approve its cost studies.

- "*The LFAM fails to comply with the Cost of Service Rule because it 'uses futuristic network rather than planned networks.'*"

This statement apparently refers to two arguments made by Staff witnesses Marshall and Green. Ms. Marshall argued that the LFAM does not comply with Section 791.40(1)(i) of the Rule, which requires that the LRSIC be based on the "locations of, and planned locational changes to, the existing network configuration." In support of this argument, Ms. Marshall asserted, without explanation, that there is no evidence that the design of the distribution system used in the LFAM is "based on the existing network configuration as required by the rule."

As Mr. Palmer demonstrated, however, Ms. Marshall's assertion in this regard is simply wrong. In fact, the investment calculations performed by the LFAM absolutely reflect the actual Ameritech Illinois network configuration data, characteristics and engineering practices. (Am. Ill. Ex. 10.2, pp. 4-7). In this regard, the main building block in the architecture used for distribution facilities is the Distribution Area ("DA"), a well-defined geographically specific portion of the wire center. (Am. Ill. Ex. 10.2, p. 4). The most significant cost drivers within the

DA are loop length and cable sheath size. (Id.). Mr. Palmer described in detail the manner by which the LFAM engineers a realistic network configuration and captures these important cost drivers for almost 12,000 DAs containing over 5.2 million circuits. (Id., pp. 4-7). By comparison, the distribution characteristics used to derive the costs reflected in the last ART filing were based on only 1600 samples drawn over ten years ago. (Id., p. 5). In fact, Ameritech Illinois developed its new methodology largely in response to criticisms received in Docket No. 96-0486/0569 regarding the age and accuracy of the distribution characteristics reflected in the old sample. (Id.).

As a result, the new LFAM develops a more, not less, accurate estimate of the Company's forward-looking DA investment based on the existing network configuration and characteristics. (Am. Ill. Ex. 10.2, p. 7). Stated another way, the LFAM effectively captures the average investment based on a snapshot of today's network using current DA design guidelines. (Id.). Mr. Palmer's testimony in this regard was unrefuted. Accordingly, there is absolutely no basis in the record to support a finding that the LFAM violates Section 791.40 of the Cost of Service Rule.

Staff witness Green asserted that the LFAM may be too "forward-looking" and reflects a design that "goes well beyond the needs to provide basic telephone service." (Staff Ex. 24.0, pp. 3-4). As Mr. Palmer testified, however, the LFAM is based on current network configuration and locations and reflects only the demand for loops expected during the study period, in this case 2001. (Am. Ill. Ex. 10.2, p. 27). Moreover, it is based on the least cost technology currently available for which prices can be determined from existing data. Contrary to Staff's assertion, therefore, the LFAM does not model a hypothetical, futuristic network. (Id.).

Furthermore, Mr. Green's concerns about the LFAM were predicated solely on the fact that the LFAM model, as applied by the Company in this case, utilized a breakpoint of 6,000 feet between copper and fiber cables in the loop. (Id.). Mr. Green observed that "today there exists copper loops of more than twice that distance." (Id.). The evidence, however, demonstrates that the 6,000 feet breakpoint is fully consistent with appropriate engineering practices and principles and complies with the "forward-looking" cost requirement of the Rule. As Mr. Palmer explained, the breakpoint represents the distance from the central office at which fiber, rather than copper, feeder cables are used. The LFAM, as does the Cost of Service Rule, requires an input for the breakpoint to model the overall average forward-looking least cost network. (Am. Ill. Ex. 10.2, p. 24). Historically, the breakpoint has been moving closer to the central office as the costs of remote terminals and central office terminals have decreased. Furthermore, bandwidth management (i.e., assigning and modifying working pairs) is easier using fiber plant rather than copper plant. In addition, fiber facilities tend to be more reliable than their copper counterparts, resulting in lower operating costs. (Am. Ill. Ex. 10.2, pp. 24-25).

As a result, if network access lines were being provided for the first time, the most economical fiber/cable breakpoint would be 6,000 feet. (Am. Ill. Ex. 10.2, p. 28). Accordingly, use of that breakpoint as an input in the LFAM complies with Section 791.20(c) of the Rule, which requires that LRSICs be calculated "as if the service were being provided for the first time." (Id.).

Moreover, changing the breakpoint to 12,000 feet (which is less economical than a 6,000 feet breakpoint), as Mr. Green suggested, would result in an increase in the LRSICs for network access lines. (Am. Ill. Ex. 10.2, p. 26). Thus, Staff's argument regarding the appropriate breakpoint provides further residential support for the Company's position that network access line service is currently priced below cost.

- *"The LFAM fails to conform with the Cost of Service Rule because it 'use[s] incorrect fill factors.'"*

As Mr. Palmer testified, the fill factors used in the Company's cost studies for drop and feeder fiber cable are based on useable capacity and, therefore, comply with Section 791.20 of the Cost of Service Rule. (Am. Ill. Ex. 10.2, p. 9). Staff witness Green argued that the Company understated the usable capacity of buried drop wire, suggesting that the usable capacity of a five pair buried drop wire is 100%. As Mr. Palmer explained, however, Mr. Green's analysis failed to take into account the fact that, when a facility such as a buried drop is dedicated to one customer, obtaining a 100% (or even 85% average utilization, as suggested by Staff witness Marshall) across all buried drops is an unrealistic expectation and will never be achieved as an average in the long run. (Am. Ill. Ex. 10.2, p. 17). As Mr. Palmer also explained, in a forward-looking design, five pair drops are placed in newer areas and are usually buried to allow for the possibility that the customer at that location may someday demand additional lines. Realistically, and from an engineering and planning perspective, however, five pairs will rarely be used. Ameritech Illinois used the value of 1.5 pairs in use per drop cable as a high estimate of the actual number of working lines per household. This results in a conservative estimate of drop costs, because the total drop investment is divided by the average number of working lines per drop. (Id., pp. 17-19).

Moreover, for reasons explained by Mr. Palmer, if the cost studies were run using Staff's assumptions regarding the usable capacity of buried drop cable, the impact on the resulting LRSICs for NAL service would be de minimus. (Am. Ill. Ex. 10.2, p. 19). Accordingly, even if the Staff's arguments regarding fill factors were correct (and they are not), those arguments do not justify a Commission decision to reject either the LFAM or the results of the Company's LRSIC studies.

- *"The LFAM fails to comply with the Cost of Service Rule because of its 'failure to reflect the demand for the entire service.'"*

Staff's argument in this regard was based on Ms. Marshall's assertion that Section 791.40 of the Cost of Service Rule should be interpreted as requiring that "the demand utilized to capture the capacity included in the LRSIC study must also be used to allocate the costs to that capacity." (Staff Ex. 18.0, pp. 5-6). Ms. Marshall, however, misinterpreted Section 791.40, which requires only that all demand for a service subject to a LRSIC study be included in the study. (Am. Ill. Ex. 10.2, p. 8). Nonetheless, as Mr. Palmer explained, the Company's cable sizing and costing methodology does, in fact, comply with Section 791.40 as interpreted by Ms. Marshall. For example, the interpretation would require Ameritech Illinois to divide the cost of the capacity required to serve 150 lines by 150 lines. If the required capacity is a 200 pair cable because 150 pair cables are not manufactured, then, according to Ms. Marshall's interpretation, Ameritech Illinois should divide the cost of the 200 pair cable by 150 lines, thereby using the demand utilized in the study (150 times) to allocate costs. That is exactly what LFAM does. (Am. Ill. Ex. 10.2, p. 9). Once, again, Mr. Palmer's testimony on this point is unrefuted.

- *" Further Staff detected what it views as programming flaws."*

The Proposed Order does not indicate what alleged "programming flaws" are being referred to in this statement. It is possible that the statement refers to Staff witness Hanson's allegation that a consultant retained by Staff to review the LFAM had encountered a "problem" operating the model while attempting to test alternative fiber/copper breakpoint assumptions. The alleged "problem," however, had absolutely nothing to do with "programming" of the LFAM. Mr. Hanson incorrectly asserted that the 6,000-foot copper/fiber breakpoint was "hard-coded" in a database. (Staff Ex. 28.0, p. 2). As Mr. Palmer explained, however, the 6,000 breakpoint is not "hard-coded." To the contrary, all breakpoints that a user may define are placed within database tables within LFAM. The "problem" Staff's consultant actually encountered was a malfunction in the Graphical User Interface ("GUI"), not the LFAM model itself. After the malfunction was discovered, the GUI was bypassed by an Ameritech programmer, who manually updated the database. All breakpoint tables that had been created prior to the GUI malfunction were available to the Staff for use in future runs. Any problems with the GUI had absolutely no impact on the accuracy of the LRSIC studies developed using the LFAM model. (Am. Ill. Ex. 10.2, pp. 10-11).

Mr. Hanson also asserted that when the LFAM model was run under alternative scenarios, an "anomalous" result was produced, thereby calling into the question the model's accuracy. (Staff Ex. 28.0, p. 4). As Mr. Palmer explained, however, the alleged "anomaly" was, in fact, created by Mr. Hanson's incorrect assumption regarding the results of the "base case" scenario. In the first alternative scenario, Staff asked Ameritech Illinois to run the LFAM using a copper/fiber breakpoint of 12,000, rather than 6,000 feet. One would reasonably expect the cost estimates produced by LFAM to increase in this scenario because fiber is the economical technology choice for loops greater than 6,000 feet. Instead, Mr. Hanson quantified the impact of scenario one as lowering the LRSIC, an apparent anomaly. However, Mr. Hanson was mistaken because the "base case" LRSIC to which he compared the results of the first alternative scenario did not reflect reductions that were made in response to errors discussed by Mr. Dunkel in his direct testimony and corrected in Mr. Palmer's Rebuttal Testimony. Using the corrected "base case" result as a starting point, the LRSIC increased under the first alternative scenario, consistent with expectations. (Am. Ill. Ex. 10.2, p. 14).

In another alternative scenario discussed by Mr. Hanson, Staff requested that the Company run LFAM using a 12,000-foot breakpoint, a 10.52% cost of money and FCC (rather than ICC) depreciation lives. Mr. Palmer testified that this scenario, like the first one, increased LRSIC because (i) the 12,000 foot breakpoint introduces more copper cable circuits, which are more expensive than fiber circuits at distances greater than 6,000 feet, and (ii) the FCC lives for the copper cable accounts are shorter than those used in the original studies, thereby increasing the annual charge factors. In sum, once the appropriate base case result is established, there are no anomalies in the results of the sensitivities requested by Staff, and the LFAM performs according to expectations. (Am. Ill. Ex. 10.2, pp. 13-14).

The testimony of Mr. Palmer, as summarized above, is unrefuted. Thus, the evidence demonstrates that the "programming flaws" which Staff claims to have "detected" simply do not exist.

- *"Staff contends that AI's interface of fiber vs. copper breakpoint length assumption are [sic] inaccurate."*

Ameritech Illinois does not understand what is meant by the phrase "interface of fiber vs. copper breakpoint length assumption" (emphasis added). As previously discussed, the Company's use of an assumed 6,000 foot breakpoint between copper and fiber in the loop is supported by the evidence and consistent with the Cost of Service Rule. Moreover, as is also discussed above, use of a 12,000 foot breakpoint, as preferred by Staff, would result in an increase in network access line LRSICs. Thus, Staff's argument regarding the appropriate breakpoint, even if accepted by the Commission, would provide more, not less, support for the conclusion that network access lines are currently priced below cost.

As also discussed above, the 6,000 foot breakpoint is not "hard-coded" into the LFAM. Thus, a determination that the breakpoint assumption used in the LFAM should be changed to

12,000 feet does not logically support a conclusion that the LFAM itself is "unreliable" or "deficient."

- *"Additionally, material costs contained within the model fail to account for any merger related savings."*

This argument assumes that there will, in fact, be a reduction in "material costs" resulting from the Ameritech/SBC merger. Staff, however, provided no support for such an assumption. Moreover, as Mr. Palmer explained, the material prices used in LFAM reflect the vendor contracts in effect at the time the cost studies were undertaken. The studies, therefore, comply with Section 791.20(c) of the Rule, which requires that costs be "based on the least cost technology currently available whose costs can be reasonable estimated based on available data." (Emphasis added) (Am. Ex. Ill. 10.2, pp. 11-12). As Mr. Palmer also explained, there is no basis to conclude that all costs of materials used in provisioning loops will decrease under new, post-merger supplier contracts. Contracts are developed for many hardware and plug-in items and there are often tradeoffs. New contracts often decrease prices for certain items while increasing prices for others. This situation is especially likely to occur here because, prior to its merger with SBC, Ameritech's vendor contracts did not match SBC's contracts. SBC may have been given bigger discounts on certain items, while Ameritech may have received bigger discounts on other items. The new combined contracts will likely contain some price decreases and some increases when compared to either SBC's or Ameritech's old contracts. Each new contract must be evaluated on its own merits as it pertains to particular LRSIC studies. (Id.).

4. The City of Chicago's Arguments Are Unsupported By The Evidence And Do Not Support Rejection Of The LFAM.

The Proposed Order contains a summary of various arguments made by the City of Chicago which are characterized as identifying "flaws of AI's LFAM." (HEPO, Section IV, City/CUB Position, par. 2). As previously discussed, however, with the exception of the City's extra-record argument that the LFAM fails to use "least cost currently available technology" (an argument which the City fabricated out of whole cloth for its initial brief and which is unsupported by any testimony, including that of City witness Dunkel), none of the City's arguments call into question the validity or reliability of the LFAM. Accordingly, even if the Commission were to find that the City's non-extra record arguments have merit (and they do not), such a finding would not support a rejection of the LFAM or its results in this case.

Each of the City of Chicago's arguments, as summarized in the Proposed Order, is addressed below. As will be discussed, the City's arguments are without merit and do not support rejection of the LFAM or any other aspect of the Company's LRSIC studies.

a. <u>The City's One Argument Concerning The LFAM Is Unsupported By Any Evidence.</u>

According to the Proposed Order, the City of Chicago argued that the LFAM failed to use "Least Cost Currently Available" technology. This argument is unsupported by the testimony of any witness, including the City's witness, Mr. Dunkel. Mr. Palmer explained in detail how the LFAM optimally redesigns and resizes facilities using forward looking technologies and assumptions, and reflects the "least cost currently available technology." (Am. Ill. Ex. 10.0, pp. 17-29; Am. Ill. Ex. 10.2, pp. 2-28). Mr. Palmer's testimony in this regard was unrebutted.

In support of its claim that the LFAM "did not use the least cost currently available technology," the City of Chicago argued in its Initial Brief that the LFAM "assumes the use of a component [central office terminal (COT)] that is neither needed nor actually used in Ameritech's network." (City Init. Br., p. 59). The fundamental (and erroneous) assumption underlying the City's argument is that the integrated digital loop carrier ("DLC") technology used in the LFAM does not require the use of a COT. (City Init. Br., pp. 59, 60, 61). In support of this assumption, the City (Init. Br., p. 59) cites Mr. Palmer's direct testimony. (Am. Ill. Ex. 10.0, p. 18). The testimony referenced, however, directly contradicts the City's argument:

> Q. Describe the model specifications for fiber optic feeder plant.
>
> A. For fiber feeder, the forward-looking design is based on the use of contiguous fiber optic facilities in combination with Litespan digital loop carrier ("DLC") transmission equipment.
>
> The DLC configuration reflected in the loop cost study uses a fiber optic facility to connect the remote terminal ("RT") to a central office terminal ("COT"), which then demultiplexes the signals through the use of plug-in circuit cards. For bundled retail network access lines, the forward-looking Litespan equipment configuration is based on the use of integrated digital loop carrier (IDLC). In this situation, the connection to the central office switch is made at a digital level and integrated directly into the switch. This is accomplished by using a different plug-in circuit card at the Litespan COT.

(Am. Ill. Ex. 10.0, p. 18). (Emphasis added). As the testimony quoted above clearly indicates, an integrated DLC configuration using a fiber feeder does require a COT for the purpose of de-multiplexing high-speed optical digital lines into lower speed electrical digital lines. The City's extra-record assertions to the contrary are unsupported by the testimony of Mr. Dunkel or any other witness and should be disregarded.

The City of Chicago claimed that, on cross-examination, Mr. Palmer "admitted that the Ameritech Illinois cost model for residential NAL did not include the use of the integrated technology." (City Init. Br., p. 59) (emphasis is original). This is a fabrication. At the pages of the transcript cited by the City in support of its assertion, Mr. Palmer did not state that the Company's cost model assumed the use of a "non-integrated" technology. Rather, Mr. Palmer simply acknowledged that the "configuration with fiber feeder" used in the LFAM assumes a COT in the central office. (Tr. 1340-41). As discussed above, use of a COT is, in fact, required for use in an integrated DLC configuration using a fiber feeder, which is the configuration used in the Company's study.

The City of Chicago also cited a portion of the transcript (Tr. 1343), in which Mr. Palmer testified that, for some loops, the Company does use an integrated digital technology that does not require a COT in the central office. (City Init. Br., p. 60). Contrary to the City's suggestion, however, Mr. Palmer was not referring to an integrated DLC using a fiber feeder. Instead, Mr. Palmer was referring to the older copper-based integrated DLC technology which does not require a COT because it uses T1 technology which can be directly interfaced with the switch. Such older copper-based integrated DLC technology was not used in the Company's forward looking cost study.

The City of Chicago also asserted that the COT properly included in the fiber-based integrated DLC configuration "converts the signal back to analog an extra time, which then has to be converted back to a digital signal at the switch itself." (City Init. Br., p. 61). Once again, this assertion, which appears no place in Mr. Dunkel's testimony, is unsupported by any record evidence and is simply wrong. The COT has nothing to do with analog/digital conversion. The COT is the infrastructure pursuant to which digital ("T1") or analog ("POTS") circuits can be separated from the optical ("OC-3") bitstream. The COT does not perform the analog conversion, but a POTS or similar plug-in card can. These POTS cards are not used in the cost study -- digital T1 cards are. In Ameritech Illinois' study, when DLC is used, only one analog/digital conversion takes place.

Finally, the City erroneously claimed that "Mr. Dunkel demonstrated that the fiber feeder configuration that Mr. Palmer used in his residential NAL cost study includes the cost of three line cards -- one more line card than is actually needed or utilized in the current 'integrated' technology." (City Init. Br., p. 61). As Mr. Palmer explained, the two plug-in cards in the COT and remote terminals are part of the integrated DLC system and both are required for the system to function. (Am. Ill. Ex. 10.3, pp. 9-10). The third line card is in the switch, and is necessary to terminate the T1 from the DLC system. Moreover, contrary to the City's suggestion, Mr. Dunkel did <u>not</u> testify that the COT is "unused and unnecessary." As discussed above, that assertion was created out of whole cloth and should be disregarded.

b. <u>The City of Chicago's Arguments Having Nothing To Do With The LFAM Are Also Without Merit.</u>

i. <u>Common Switching Costs.</u>

According to the Proposed Order, the City of Chicago asserted that " AI improperly included 'common costs' of a switch in the port cost". In fact, the City's argument regarding common switching costs had nothing to do with the LFAM. While "port costs" are included in the network access line LRSIC, such costs are not a product of the LFAM. Rather, port costs, as with other portions of the switch investment costs, are developed using the ARPSM.

Furthermore, as in the case of the City of Chicago's "least cost" argument, discussed above, the City's argument that it was improper to include any "common costs" in the cost of ports was an argument made by the City for the first time in its Initial Brief and was unsupported by the testimony of GCI witness Dunkel or any other witness. As the Company discussed in its Reply Brief (p. 100), the costs at issue here are not common overhead costs of the type which are to be excluded from the calculation of LRSIC pursuant to the Rule. Rather, the "common costs" being referred to are hardware and software costs needed to make the switch work. Accordingly, a portion of such costs is appropriately reflected in the cost of the port.

Mr. Dunkel did not testify that it was improper for the Company to include any portion of the common hardware and software costs of the switch equipment to the port for the purposes of calculating network access line LRSICs. Rather, Mr. Dunkel contended that the Company had improperly assigned 100% of such cost to NAL service. (GCI Ex. 8.0, pp. 48-50). Mr. Dunkel's argument was based on a misunderstanding of the method which the Company's ARPSM model uses to identify Centum Call Seconds ("CCS") related costs. As Mr. Palmer explained, none of the vendor contracts contain an explicit price for CCS. Instead, the contracts specify only a single per-line price, which includes all line-related, usage-related, and "common" related hardware and software costs. The Company, therefore, requested additional information from the switch vendors that would allow the Company to identify an implicit or assumed CCS component of the total per-line price. Under this methodology, any costs associated with common equipment that are inherent in the single per-line prices of the vendors are, by default, assigned to lines and usage in proportion to their respective implicit costs. (Am. Ill. Ex. 10.1, p. 20). Mr. Dunkel's suggestion that 100% of the common costs were assigned to NAL service is, therefore, incorrect.

ii. Network Interface Device.

The Proposed Order states that "City charges that AI improperly double counted the costs of installing the network interface device." Once again, this argument has nothing to do with the LFAM. The costs of the network interface device ("NID") are costs added to the results of the LFAM in calculating network access line LRSICs.

In support of the City of Chicago's allegation that NID costs are double-counted in the Company's LRSIC study, Mr. Dunkel asserted that the study improperly assumes that a new NID is tested three times at each installation. (GCI Ex. 8.0, p. 46; GCI Ex. 9.0, p. 65). As Mr. Palmer explained, however, the tests referred to by Mr. Dunkel represent three separate tests performed for three different purposes. (Am. Ill. Ex. 10.3, pp. 23-24). Moreover, because each of these tests is not performed 100% of the time, the cost estimates reflect a frequency-of-occurrence factor that is used to produce a weighted average installation cost. (Id., p. 24). Accordingly, there is no "double-counting."

iii. Line Mix Assumption.

The Proposed Order states that, according to the City of Chicago, the "LFAM failed to address what the City calls a line mix assumption." As previously indicated, the City never made such an argument about the LFAM. The "line mix assumption" dispute involves application of the ARPSM switching investment cost model.

Moreover, the evidence fully supports the replacement and growth line mix assumption made by the Company in applying the ARPSM. As Mr. Palmer testified, switch vendors charge two separate prices for installing switching capacity on a per-line basis. One per-line price applies to a limited number of lines on analog switches specifically identified in the contracts as being replaced with digital switches, while a higher price applies to growth lines installed on existing digital switches and growth lines subsequently installed on "replacement" switches. (Am. Ill. Ex. 10.1, p. 22). ARPSM combines these two prices with the quantities of lines expected to be installed at each price in each year of the contracts. In doing so, it generates the single price that the vendor would charge, were it to replace its two-tiered pricing structure in its most recent contract with a single per-line price. (Id.). This price per line represents the best estimate of the average forward-looking market price the switch vendors would charge Ameritech or any similarly situated carrier for any quantity of lines purchased and is, therefore, the appropriate price estimate to use in LRSIC analysis. (Id.).

Mr. Dunkel proposed an adjustment to the LRSIC for network access line service to reflect a mix of replacement and growth lines different than the mix assumed by the switch vendor contracts. (GCI Ex. 8.0, p. 51). Mr. Dunkel's approach would distort the actual forward-looking price contemplated by the vendors and the carrier at the time the contracts were negotiated, and, therefore, is inconsistent with the requirements of the Rule, which states the following regarding input prices:

> "Input prices. Each cost study shall reflect input prices (e.g., the prices for materials, labor, and capital) that the carrier is actually expected to face. The carrier shall provide the underlying bases for projected changes in input price levels, using, wherever possible, projections based on market expectations and rates set in labor contracts. Where appropriate, costs shall be based on prevailing vendor prices or vendor prices under consideration that reflect volume discounts or term discounts off listed input prices. These discounts shall be reflected in the cost study." (emphasis added) 83 Ill. Admin. Code Section 791.60(c).

Ameritech Illinois' ARPSM methodology meets this standard. (Am. Ill. Ex. 10.1, pp. 23-24).

iv. "Revenue Ready" Fees.

The Proposed Order refers to the City of Chicago's argument objecting to the inclusion of "revenue ready" fees in the calculation of network access line LRSICs. Once again, this issue relates to application of the ARPSM, not the LFAM. "Revenue ready" fees are associated with line ports installed on switches and are assessed on a per-line, per-year basis by switch vendors to compensate them for traffic engineering and provisioning functions, as well as for any processor upgrades and new switch generic releases. (Am. Ill. Ex. 10.0, p. 34; Am. Ill. Ex. 10.3, p. 3). Mr. Dunkel argued that "revenue ready" fees were improperly included in the line termination costs. (GCI Ex. 8.0, pp. 51-52). Mr. Dunkel's argument is without merit. The only way for the Company to avoid paying "revenue ready" fees would be to provide no line ports, and, therefore, no NAL service. The vendor contracts are clear and provide no basis for assigning "revenue ready" fees to other services. Stated another way, revenue ready fees must be paid if Ameritech Illinois is to provision network access lines and, therefore, these fees must be paid if the Company is to provision network access lines. Consistent with the Rule's cost causation principles, therefore, the Company correctly assigned revenue ready costs to NAL service. (Am. Ill. Ex. 10.3, p. 3).

v. Billing Costs.

According to the Proposed Order, the "City claims that it is inappropriate to include the costs of receiving and processing payments for several services as costs attributable to network access lines." While this argument goes to the appropriateness of including billing costs in the calculation of network access line LRSICs, it has nothing to do with the LFAM, i.e., the loop facility investment model.

Moreover, the City of Chicago's argument is without merit. In support of the City's position, Mr. Dunkel argued that the Company's assignment of billing costs to NAL service is improper because a variety of other services, including toll services and vertical services such as Call ID and Call Waiting, are also supported by such costs. (GCI Ex. 8.0, pp. 52-54). Mr. Dunkel's argument is inconsistent with the Rule's cost causation principle, which requires that the service which initially causes a cost to be incurred must be assigned that cost. 83 Ill. Admin. Code Section 791.30. (Am. Ill. Ex. 10.3, p. 6). Billing costs are brought into existence as a direct result of customer demand for network access lines. If a customer orders only a line and no other services, that customer must still be billed, an account must be established, a statement must be prepared, paper and envelopes must be used, postage must be paid, and the customer's payment processed. Conversely, none of those costs can be avoided if none of the vertical features or other services referenced by Mr. Dunkel are utilized by the customer. In accordance with the cost causation principle, therefore, billing costs are properly assigned to the NAL. (Am. Ill. Ex. 10.1, pp. 24-25; Am. Ill. Ex. 10.3, pp. 6-7).

vi. Capital Costs.

The Proposed Order states that the City (i) "rejects AI use of 'Cost of Capital' in its LFAM" and (ii) contends that AI's LFAM considers an inflated "net investment." As previously discussed, these arguments have nothing to do with the validity or reliability of the LFAM.

Ameritech Illinois' cost models use a weighted cost of capital for LRSIC studies calculated in a manner consistent with Section 791.80(b)(1) of the Rule. (Am. Ill. Ex. 10.0, p. 10, Sch. 2; Am. Ill. 10.1, pp. 25-28). Specifically, the cost of money was calculated in the basis of a forward-looking capital structure and reflects the cost of equity (11.97%) which the Commission approved for use in the LRSIC studies adopted in the 1994 Order. (Am. Ill. Ex. 10.0, pp. 26-27; 1994 Order, at pp. 89-90). Mr. Dunkel criticized the Company's forward-looking capital structure and proposed the use of an overall cost of capital (9.74%) lower than the cost rate used in the Company's LRSIC studies. Mr. Dunkel, however, understated the cost of capital by assigning a cost rate to common equity of only 11.80%, which is less than the equity cost rate (11.97%) approved for LRSIC study purposes in the 1994 Order, and less than the current cost rate of 13.10% recommended by Staff on the basis of the expert analysis presented by Mr. Pregozen. (Staff Ex. 25.0, p. 2). GCI presented no evidence to support a finding that the cost of common equity for Ameritech Illinois is as low as 11.80%. In this regard, Mr. Pregozen recommended an overall cost of capital for LRSIC purposes of 10.75% , which is higher than the value assumed in the Company's studies, and more than 100 basis points higher than Mr. Dunkel's recommendation. (Staff Ex. 25.0, Sch. 25.01). Accordingly, Mr. Dunkel's criticism, the cost of capital reflected in the Company's studies, was unfounded.

Mr. Dunkel also alleged that the average net investment upon which the cost of money factors are calculated is overstated in the Company's studies. (GCI Ex. 8.0, pp. 56-60). Mr.

Dunkel's allegation was based on an assumption that over the life of facilities, net average investment averages 50% of gross investment. As. Mr. Palmer explained, Mr. Dunkel's 50% net investment scenario only works in theory if all units of property within an account have actual service lives equal to the average service life assumed for that entire account. In the real world, however, some units remain in service longer than average and some units are retired after service lives shorter than the average. (Am. Ill. Ex. 10.1, p. 30). Unlike the model used by Mr. Dunkel, Ameritech Illinois' CAPCOST program captures these survivor effects. (Id.).

In addition, the CAPCOST program properly reflects straight-line equal-life group depreciation ("ELG"), a refinement of straight-line depreciation accounting which allows the total allowable lifetime depreciation of any item to be accrued at a depreciation expense over its actual life, whether it is longer or shorter than the average. When compared with the straight-line vintage group method, ELG will shift more of the capital repayment costs for a group or account towards the early years, which is reflected in the average reserve calculated by CAPCOST. (Am. Ill. Ex. 10.1, pp. 32-33). Mr. Dunkel's capital cost model does not properly apply the ELG method. (Am. Ill. Ex. 10.3, pp. 13-14).

As Mr. Palmer testified, the CAPCOST model used in this proceeding is essentially the same as the model which the Company has been using since the mid-1980s. Although CAPCOST inputs, such as average lives, costs of money and capital structure have been debated during the time period, the basic CAPCOST methodology and model have never been questioned. (Am. Ill. Ex. 10.1, p. 35). On the other hand, the capital cost model used by Mr. Dunkel to calculate the annual cost factors which he recommended has never been used in an Illinois cost of service proceeding. (Am. Ill. Ex. 10.1). For these reasons and the other reasons discussed above and in Mr. Palmer's testimony, the City of Chicago's criticisms of the capital costs used by the Company in calculating LRSICs are without merit. (Am. Ill. Ex. 10.3, p. 15).

CONCLUSION

For the foregoing reasons, Ameritech Illinois' Exceptions to the Proposed Order in this proceeding should be adopted.

Respectfully submitted,

ILLINOIS BELL TELEPHONE COMPANY

by ____________________________
One of its Attorneys

Louise A. Sunderland
Karl B. Anderson
Mark A. Kerber
Attorneys for Ameritech Illinois
225 West Randolph Street
Floor 25D
Chicago, IL 60606
(312) 727-6705
(312) 727-2928
(312) 727-7140

Edward A. Butts
1800 West Hawthorne Lane, Room 102
West Chicago, Illinois 60185
(630) 562-1515

.

CERTIFICATE OF SERVICE

I, Louise A. Sunderland, an attorney, hereby certify that copies of the foregoing Brief on Exceptions of Ameritech Illinois were served upon the parties on the attached service list via electronic mail and/or by Federal Express on June 13, 2001.

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Louise A. Sunderland

SERVICE LIST FOR

I.C.C. Docket No. 98-0252/98-0355
(Consol.)

Jack A. Pace
City of Chicago
Public Utilities Unit
30 North LaSalle St., St. 900
Chicago, IL 60602-2580

Karen Lusson
Citizens Utility Board
349 South Kensington Avenue
LaGrange, Illinois 60525

Allan Goldenberg
David Heaton
Assistant State's Attorneys
Public Utilities Division
69 West Washington, Ste. 700
Chicago, Illinois 60602

Phillip Casey
Hearing Examiner
Illinois Commerce Commission
160 N. LaSalle, Ste. C-800
Chicago, Illinois 60601

Matthew L. Harvey
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street, Ste. C-800
Chicago, Illinois 60601-3104

Cheryl L. Hamill
AT&T Communications
222 W. Adams St., Ste. 1500
Chicago, IL 60606

Clyde Kurlander
Attorney for XO Illinois
Three First National Plaza
Suite 2315
Chicago, IL 60602

Eve Moran
Hearing Examiner
Illinois Commerce Commission
160 North LaSalle St., Ste. C-800
Chicago, IL 60601

Darrell S. Townsley
MCI Telecommunications Corp.
205 N. Michigan Avenue, St. 3700
Chicago, IL 60601

Calvin Manshio
Manshio & Wallace
4753 N. Broadway Ave., Suite 732
Chicago, IL 60640
[Hard copy on 3/22/01 only; no electronic service.]

John E. Rooney
Sonnenschein, Nath & Rosenthal
8000 Sears Tower, Suite 7800
233 South Wacker Drive
Chicago, IL 60604

Peter Nyce, Jr.
Department of the Army
901 N. Stuart Street
Arlington, VA 22203

Henry Kelly
Joseph E. Donovan
O'Keefe Ashenden Lyons & Ward
30 North LaSalle, Suite 4100
Chicago, IL 60602

Michael Ward
Michael Ward, P.C.
1608 Barkley Blvd.
Buffalo Grove, IL 60089

Susan Satter
Assistant Attorney General
100 W. Randolph Street, 11th Floor
Chicago, IL 60601

Owen E. MacBride
Terri Brieske
Schiff Hardin & Waite
233 South Wacker Drive
6600 Sears Tower
Chicago, IL 60606

Dennis Muncy
Joseph Murphy
Matt Deering
Meyer, Capel, Hirschfeld, Muncy, Jahn & Aldeen P.C.
306 West Church Street
Champaign, IL 61826-6750